

Banking and Capital Markets

Custody: a business at the crossroads

Transaction Banking Compass

Custody is supposed to be a boring transactional business where size counts and consistent revenues keep the machine well oiled.

However, custodians are not immune from the volatility that has hit the market over the last year. While this has not threatened their survival, it has thrown open some new opportunities and threats to add to those that were already in play. The custody business is at a crossroads with some fundamental decisions required that will decide the winners and losers over the next 10–20 years.



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How did we get to the crossroads?

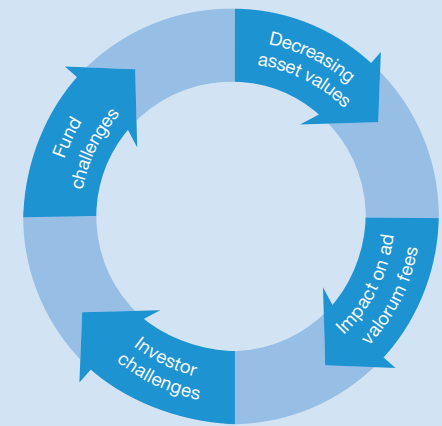
In general, the volatility that hit the markets provided a positive boost for the custodians' business model. Their limited proprietary risk-taking and large balance sheets resulted in many institutions using them as a safe harbour in the storm. Also, the risk of insolvency among the broker dealers resulted in a number of funds moving their custodial relationships to direct relationships with the larger players. As a result, the custodians have been extremely busy with new accounts, large amounts of liquidity and new assets to manage.

This all sounds positive, but the disruptions in the market and global recession has resulted in:

- the value of assets decreasing rapidly;
- a reduction in active trading; and
- a large volume of redemptions by investors as they seek safer assets during the downturn.

The custodian business model is heavily dependent on safekeeping fees as a percentage of assets under management (AUM) and also per transaction asset movements. There is therefore a resulting reduction in revenues during a period of increased internal activity to support the funds. In addition (see Figure 1), the end customers – the funds – are having their own fees challenged by investors as performance falls, which will in turn impact on their own focus on the costs of their service providers – the custodians.

Figure 1: A reinforcing cycle of pressure



Source: PricewaterhouseCoopers

From bad to worse

The cost situation is likely to get worse rather than better, given the backlash from politicians and regulators following the financial crisis. One of the key areas that will impact this part of the financial services industry is transparency.

A key tenet of recent regulation is market disclosure as a mechanism for allowing the market to self-regulate (Basel Pillar III). While there are question marks over whether the market is able to self-regulate, the discovery of ponzi schemes at Madoff investments and Stanford Investments is leading to focus in this area (e.g. Turner Review).

From factory to information services

The lack of due diligence on funds combined with ongoing concerns about the quality of disclosure of information to investors will inevitably result in new regulatory requirements. If we follow this down through the value chain of service providers, the custodians will inevitably be critical in servicing the information requirements, given that they are safekeeping the assets. This will reinforce an existing trend where the hedge fund community continues to demand improved information in terms of speed, quality and accuracy, to assist them in executing their investment strategies. As a result, custodians are entering a world where regulators and customers will demand that they are more than transactional factories, but can also deliver as an information business.

Beware the danger from below

It has been the transactional nature of the business that has driven consolidation among competitors to date. According to Global Custodian's annual survey, today just four banks directly or indirectly control three out of every four dollars in global custody. Yet this picture masks the 'danger from below'.

The most significant competition to the core business is coming from the central securities depositories (CSDs) as they continue to encroach on the low-cost safekeeping and transactional local market access parts of the business. This, plus the need to continue growing profit margin, continues to force the custodians vertically up the value chain into other value-added services or horizontally into other products and markets.

Where do we go from here?

The changes in the market have thrown open a vast number of opportunities for custodians, but are also placing a lot of pressure on investment and resources. The business and operating models are facing pressure in terms of customer demands for improved service and flexibility. This is exacerbated by reducing AUM, which is placing pressure on revenues, which is in turn putting pressure on costs to keep margins up. In addition, the regulatory reaction will inevitably place a focus on control, data and transparency, requiring further spending. So what are the opportunities open to custodians at this junction in the crossroads and where to focus the investment?

We see four potential strategic options (see Table 1).

Table 1: Strategic options

| Strategic play | Focus | Opportunities |
|------------------------------|--|---|
| The consolidator | Acquisition and well-executed integration Low-cost operating model with distributed sourcing of functions | Smaller competitors in niche markets or products Reinvigorating the 'lift out' product for fund back offices |
| The service provider | Investment in service culture and information – quality, accuracy and speed | Direct custodian of choice for larger hedge funds |
| The product innovator | Research and development, re-evaluating core competencies vs. infrastructure requirements in the industry | Standardising and processing various derivatives Building or partnering to develop infrastructure needs around central counterparties, messaging standards |
| The market builder | Macro view on market opportunities and building contacts within growth markets | Using skills and technology in new growth markets to build local infrastructure, e.g. emerging market CSDs Target growth markets where using other custodians for local market access and either acquire or build own capability |

Source: PricewaterhouseCoopers

The consolidator – Despite consolidation to date, there are continued opportunities to build scale and add more transaction volume to the factory to reduce unit costs. This can take the form of a reinvigoration of the ‘lift out’ product for fund back offices or buying custodians in existing markets to create savings through synergies. Alternatively, there are ‘fill in’ opportunities where custodians can see opportunities to acquire or build in profitable parts of the network where they are currently using other providers. This consolidation strategy essentially focuses on cost and so is likely to be accompanied by a continuing focus on the efficiency of the operating model, increasing the manufacturing capability to reduce unit costs and taking advantage of opportunities to source functions from a variety of lower cost locations.

The service provider – During the liquidity crisis funds have turned to the custodians as a port in the storm. However, there is a window of opportunity to maintain and grow these direct relationships if they can meet the service levels that are required. Initial feedback from the market suggests that this is unlikely with continued question marks over servicing capability, lack of innovation and flexibility. The question remains over whether a large transactional business built on reducing costs and standardisation can realistically make this change to its core culture. While feedback to date suggests service and innovation is not an option in the short term, the fact that this is not perceived as a strength in the industry suggests there is an opportunity here, given demands from customers, investors and regulators.

The product innovator – The financial services industry has expanded and innovated rapidly over the past 20 years and the market infrastructure has not caught up. Custodians play a key role in this infrastructure with the core competencies and resources to deliver solutions to the gaps that have appeared: from derivatives to data. The derivative market in particular has grown phenomenally, partly a result of the growth in the hedge fund industry, but increasingly with the traditional institutional investors making use of these instruments following the introduction of Undertakings for Collective Investments in Transferable Securities (UCITS) legislation. This is an area of continuing opportunity, given the size of the market, but requires new skills and systems. Smaller technology providers and the CSDs (e.g. Depository Trust & Clearing Corporation (DTCC) Deriv/SERV) are focusing on this, with a danger that custodians are caught in the middle of the more nimble small competitors and large market infrastructure players.

The market builder – The BRIC economies (Brazil, Russia, India and China) and the petro-economies of OPEC have been impacted by the global recession like all countries. Despite this, the inevitable trend from the mature economies of the West to new economies with limited and unsophisticated infrastructure is clear. Custodians have specialised in building core transactional infrastructures, founded on connectivity and messaging that are both robust and always available. Given these core competencies, there are opportunities in a number of markets to work with local governments on developing their infrastructures. The inevitable benefits lie beyond the project-based fees, and in the longer term relationships as well as the ability to gain some form of role/ownership in all or key parts of the value chain.

Strategic option summary

Table 1 provides an overview of the strategic options. As you seek to navigate through the current malign market conditions, you need to be clear about:

- where you are;
- what do you want to be; and
- which route is best for you.

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