International Securities Services Magazine Roundtable

Sub-custody

ISS Magazine talks to Rob Scott at Commerzbank, Jessica Hynes at Mercer, and Andy Duffin at Societe Generale about the major issues facing sub-custody.

Rob Scott
Head of Custody & Collateral Solutions
Commerzbank

Jessica Hynes
Senior Associate, Head of Custody Consulting - UK, Europe & Middle East
Mercer Sentinel

Andy Duffin
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Societe Generale Securities Services

ISS Magazine: What would you identify as the major issues facing sub-custody today?

Rob Scott, head of custody and collateral solutions,

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> *- Rob Scott*

Commerzbank: In general terms it's likely that sub-custodians are often challenged with aged technologies which lead to cost and efficiency issues. This is not only true of them, but also for the global players. The securities community for the most part is burdened with aged technology, with most investment in recent years going to front office trading units, or lately to the numerous regulatory challenges. Even those organisations with seemingly unlimited investment are spending a significant part, if not all of the available funds in complying and keeping pace with regulatory change. Innovation budgets are considerably challenged at a time when frankly innovation is needed the most in order to bring the cost of operations and technology to commercially viable long-term, sustainable models.

Scalability is always a question. However, if you operate in a major market with good levels of flow business and activities it's still relatively easy to navigate a successful business model. If you have a thorough and comprehensive understanding of your client community and detailed knowledge of them and their operating needs, and as long as you remain truly focused on bringing value and delivery in those areas of need and where you have proprietary advantages, your long-term commercial viability is generally not in question. Trying to be all things certainly brings about challenges in today's post-trading environment.

Andy Duffin, managing director, head of sales and relationship management, emerging markets, Societe Generale Securities Services: The ever-increasing regulatory workload upon sub-custodians and network managers is now very much viewed as business as usual. As such one of the most significant issues today is redefining the service model for sub-custodians and the network strategy as a client.

The increasing ability to unbundle services is creating multiple options for both service providers and purchasers with new entrants in certain areas. How to best leverage these options is still not fully defined and will be played out over the coming years increasingly as the T2S go live waves are reached. Regulation along with the changing service model options are forcing network managers to consider issues which may not have always been a primary topic on their agenda, for example intra-day liquidity. The conversations we at Societe Generale Securities Services are having with our clients today are very different now to the ones we were having a few years ago and we are proposing new services.

Jessica Hynes, senior associate, head of custody consulting - UK, Europe and Middle East, Mercer: Probably asset segregation and AIFMD. It's all about liabilities at the end of the day.

ISS: Have those changed in any significant way in recent times?

Rob Scott: The cost of regulatory compliance and attaining a balance of core service provision coupled with maintaining good levels of innovation have always been challenges to the sell-side. Yes, in today's regulatory focused environment this is certainly heightened and provides numerous challenges. However, if you remain focused and targeted in your client delivery, you can still sustain your business model in the longer term. The difference now is there is more of an open dialogue with both client and custodian regarding the consumption of services on both sides. There are very clear trends that rewarding clients for high levels of performance with high STP (straight-through-processing) and minimal human interaction, or in the provision of a range of ancillary services, often upon review are no longer needed, and very often a function simply of historic or bad setup or operating practice.

Jessica Hynes

Senior Associate, Head of Custody Consulting - UK, Europe & Middle East - Mercer Sentinel

Jessica Hynes is the Head of Global Custody Consulting for the UK, Europe and Middle East within the Mercer Sentinel® Group. An industry expert in global custody, she is responsible for sales, strategy and product for Mercer Sentinel's custody practice. She also is responsible for ongoing custodian monitoring, the maintenance of Mercer's proprietary database of global custodian capabilities and custodian selection exercises for major UK and European pensions and Middle East sovereign wealth funds.

Jessica is a 25 year veteran of global custody who joined Mercer Sentinel in January 2011. She began her career in 1991 in Luxembourg with Brown Brothers Harriman, a private US global custodian bank managing offshore fund operations. She relocated to London in 1998 and has held a variety of senior Relationship Management and Sales roles at J.P. Morgan, State Street and HSBC Securities Services servicing Asset Managers and Asset Owners.

Mercer Sentinel® Group is a specialist consulting group for post-trade securities operations within Mercer Investments. Mercer Sentinel has a team of over 50 specialist operational experts in London, Sydney and Chicago. The team provides consulting on Custody, Operational Risk and Transition Co-ordination, supporting institutional investors, major pension schemes, sovereign wealth funds and investment managers.

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The custodian industry generally has been poor at both accepting the “race to the bottom” in terms of pricing, as well as in educating clients about their consumption of core services. Historically, pricing policies and practices has often encouraged custodians not to point out or highlight client inefficiencies or bad practices. In today’s environment efficiency, transparency and streamlining activities is of paramount importance.

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> *- Jessica Hynes*

Andy Duffin: To a certain extent many of these options have always existed and were in a limited number of cases utilised. So it is not a new concept; it is more a case of the options available increasing.

Jessica Hynes: AIFMD is a relatively new feature on the sub-custody regulatory spectrum. Looking to banks to take liability for operational risk is new. In this context, balance sheet strength becomes even more important than before.

ISS: If so, how? Is this for the better or worse?

Rob Scott: My view is that the advent of large regulatory reforms on a global scale has been and will continue to be of tremendous benefit to all involved in this industry. There is a much better and comprehensive understanding of service consumption, in inefficiency and its consequences and in terms of service providers having much clearer and better understanding of the risks they subscribe to on a daily basis, be that liquidity risks or in the better assessment of counterparty credit issues and onboarding assessment.

It has also been hugely beneficial in starting to define proprietary and sustainable business models. I believe that the days of the big universal banks being “all things in all markets to all client segments” will continue to be a thing of the past. Banks and service providers will continue to reshape their commercial business models and refocus their activities. This can only be great for the industry overall and its participants. We will continue to see over the coming years in some cases large and to some no doubt, surprising moves and exits from business lines. The net effect being a long-term, sustainable business environment whereby fair pricing, transparency and focus around consumption is properly understood.

Finally, what will also emerge for those able to be focused and nimble in their delivery, is the emergence of a range of new products and services due to regulation. The advent and adoption of new technologies and process efficiencies will bring about new ways of operating commercially and the replacement of traditional revenue streams which have underpinned and remained largely consistent within the community.

Andy Duffin: I have been part of our industry for nearly 30 years and change has always been the one constant. Any opportunity to re-examine the way in which we service our clients can only be good for all involved.

Jessica Hynes: It’s better for investors to know that risks are being supported by banks, but it is much harder for banks to have those liabilities imposed upon them.

Rob Scott

Head of Custody & Collateral Solutions - Commerzbank

Prior to joining Commerzbank, Rob was instrumental in the creation of an industry Securities Post Trade Utility in Accenture enabling Banks, Broker Dealers and Financial Institutions the ability to outsource their Back- and Middle-office-functions globally. Prior to this, Rob globally ran the Securities Clearing and Financing business in the Domestic Custody Service Group at Deutsche Bank, responsible for both product and sales areas. Rob has held a variety of senior positions running global operations and advising on global client strategies for Banks, Broker Dealers and Financial Institutions and has worked amongst others with Citigroup and Bank of America.

ISS: Would it be fair to say that in an increasingly uncertain world, long-term partnerships with local institutions are of greater importance than ever?

Rob Scott: As banks, service providers and clients redefine their business models, the ability to recognise your proprietary advantages quickly and to partner and collaborate with others who have greater efficiency, scale or capabilities in areas where there is little to no advantage to yourself, is of paramount importance.

In order to sustain long-term commerciality, recognition and acting quickly in these areas are essential in order to truly differentiate and focus on areas where you retain core competency. No longer is it an advantage for banks, for example, to have huge back and middle offices and build huge, complex technology platforms, which for the most part all perform the same functions. People are now thankfully less proprietary in their thinking and this will give rise in the next five or so years to increase outsourcing, coupled with business collaborations which benefit all.

Andy Duffin: Building long-term partnerships has always been extremely important. In the context of this question it is important to differentiate between a local bank operating in one or two markets versus one which is attached to a universal bank with global reach. When considering whether a sub-custodian represents a good long-term partner a network manager has to look beyond the local custody activities. It has to also consider the banks' other activities in the market as well as its activities and strategy at a regional, global and business line level. Commitment to the business does not necessarily mean longevity of service. We have seen there are lots of factors which can impact whether a chosen partner bank remains over time the right one. It is now more than ever a critical part of the selection process to consider these factors.

Jessica Hynes: Banking relationships are best when they are stable, and remember, in sub-custody only a limited number of partners may be available, particularly in emerging markets. Everything comes down to great relationships.

ISS: What are the essential requirements of a sub-custodian? Strong parent and balance sheet? Experienced staff? First-class relationships with local financial infrastructure and regulatory bodies?

Rob Scott: There are many facets and advantages to local custodians. They bring about levels of local expertise and understanding which are usually unparalleled. Their knowledge of clients and their respective activities is usually far more comprehensive, enabling them to bring about solutions which bring real and tangible benefits to their clients. Due to their size and focus, they are often able to be nimble in their client solutions and in providing a quick time to market on initiatives and market and regulatory adaptations.

Their understanding of and connectivity to local infrastructures, people of influence, regulators and various market participants are deep and advantageous to clients seeking strong market advocacy and representation at a local level.

The ever-increasing regulatory workload upon sub-custodians and network managers is now very much viewed as business as usual... one of the most significant issues today is redefining the service model for sub-custodians and the network strategy as a client. - Andy Duffin

Above all else, local custodians offer a client service experience which is often unique in today's "service centre/ centralised" approach. There is very often stability in the client engagement model and relationship management. Again this is often a criticism heard of larger universal organisations which in recent years seem to have somewhat of a "revolving door" approach to clients and in the relationship management of day-to-day services. It's virtually impossible to understand your client in a very holistic and comprehensive manner if relationship support changes with high frequency. Local custodians are very often rightly proud of the fact that

Historically people entered markets with the anticipation of volume and the hope of being commercially successful. Now, there is more business scrutiny from clients who need to properly align with their end-client or proprietary needs.
- Rob Scott

their success is measured on the longevity of the client relationship and making the client central to how they measure their success.

Andy Duffin: Increasingly clients are focusing more on risk during the selection process. Clients are digging deeper into local market law and regulations in particular around restitution of assets. They are asking more in-depth questions around business continuity, IT security and demanding more stringent internal controls and automation.

Jessica Hynes: Most sub-custodians are members of a large international banking group, so the majority of assets are in the care of the major banks which are all interlinked in one way or another. Many banks are both clients and competitors of each other. This domination of big international banks reflects the importance of having a strong balance sheet. Only in emerging markets will you find local banks operating, and you will find that a couple of major banking groups are the dominant players in the larger EMs. They have the expertise and first class relationships needed to get things done with stock exchanges and regulators.

ISS: How are these changing, if at all?

Rob Scott: My feeling is that the essential requirements of sub-custodians have always been and will continue to be the same today as they were yesterday. Of paramount importance is the need to truly understand your client and the ability to service them locally in their language, and in a manner which they are used to and comfortable with. The need to strike an effective balance of optimising P&L to the level where client interaction and relationship is distanced and at worse, potentially compromised is a recipe for disaster. A balanced approach and, if working with clients an open, equitable relationship manner, are always the secrets of long-term success.

Andy Duffin: Risk has always been a key component of the selection criteria; however regulation has required clients to have a greater focus on this topic in particular when acting in a depository bank capacity.

Jessica Hynes: Stronger reporting and enhanced operational security are expected as standard now. People want to find out what is going on in a local market the same day, not overnight.

Andy Duffin

Managing Director, Head of Sales & Relationship Management, Emerging Markets - Societe Generale Securities Services

Andy Duffin has been with Societe Generale Securities Services since 2007 and is currently Head of Sales, Emerging Markets. He has over 25 years experience within the securities services industry having begun his career within the custody division of the Royal Bank of Scotland plc in 1987. Following a 10 year period at the Royal Bank of Scotland plc he joined the network management group of Deutsche Bank AG where he headed the team in EMEA. In 2005 he joined Clearstream Banking as a Sales and Relationship Manager based in London.

ISS: Are there natural limits to how far outside institutions might penetrate into so-called emerging markets?

Rob Scott: Both clients and service providers are often drawn to emerging or frontier markets due to the levels of returns in those given markets. This applies both to the client in terms of P&L generated from trading activities either locally or in their ability to arbitrage respective markets. The only difference today is that historically people entered markets with the anticipation of volume and the hope of being commercially successful. Now, there is more business scrutiny from clients who need to properly align with their end-client or proprietary needs.

There is far more rigour around entering a market and a full and comprehensive understanding of the local risk models and dynamics from, for example, fully understanding local infrastructure and its respective regulatory environment to understanding counterparty credit perspectives.
From a service provider perspective the days of "build and they will follow" are long gone. Unless being in that market is paramount to your client needs or meaningful from a proprietary perspective, it's unlikely you will attract sufficient volume and be able to invest and develop sufficient levels of product delivery to make it commercially viable in the long-term. This is a major contributory factor in why we continue to see exits from markets or product types by the sell-side community.

Andy Duffin: There are definitely limits and the question needs to be addressed in the context of the client segment concerned. It is most definitely more challenging for an outside institution to penetrate domestic clients such as providing a depository bank service. Domestic clients tend to favour local banks, in particular those which can deliver an efficient service by utilising the global infrastructure of a parent company.

Jessica Hynes: Certainly there is a cost-benefit dynamic to consider. If a market is very small and thinly traded, there is not much room for more than one or maybe two players and there really is not any room or need for more players. It is not so much a safety concern, more a question of whether there is enough business, competition and issues. If not, why would one of the big international players want to be there?

ISS: Is the pace of expansion by global custodians into such markets slowing? Does this highlight the need for the sub-custodian?

Commerzbank: The pace of global custodians expanding into frontier/emerging markets is certainly slowing. There are even quite recent examples and trends of organisations withdrawing from markets and localised activities. This is again often a result of organisations trying in the past to be all things to all clients, in all markets, products and currencies. As large banks begin to understand and rediscover their proprietary strengths and identify markets where they truly have strongly aligned client interests, I foresee this trend continuing and more exits and product/service reshaping ensuing.

Banking relationships are best when they are stable, and remember, in sub-custody only a limited number of partners may be available, particularly in emerging markets. Everything comes down to great relationships.
- Jessica Hynes

In turn, this gives local service providers the chance to shine once again and to find commercial strength where once they were challenged by the large global custodians which very often served to force prices to unsustainable levels by competing for business at all costs in order to keep clients happy; often compensating from a P&L perspective in other areas of their business activities with the same client, or loss leading for sake of overall relationship reasoning purposes. Regulation and greater levels of transparency have served to stop and curtail this activity as legal entities and business lines need to need to stand up commercially, as this now leads to drains in capital usage or balance sheet consumption.

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> *- Andy Duffin*

However, whilst local sub-custodians will continue to provide necessary expertise and client solutions at the local level, I do not foresee the return of commercially sound models for multiple local providers to co-exist in the same markets. We will likely therefore see some local providers fall away all together or consolidate further.

Andy Duffin: The expansion of global custodians into new markets is definitely slowing. The number of new markets added to their networks year on year is very light.

Jessica Hynes: In terms of the largest players, only a handful are truly global AND local. The two largest global custodians have little or no network of their own to speak of and are quite happy to outsource this function to the sub-custody specialists.

ISS: Can you point to one or two instances, without betraying confidences, where a sub-custodian has demonstrated its value beyond any shadow of a doubt?

Rob Scott: There have often been many examples where the client gets into difficulty with a trade or series of transactions. Local custodians often have the ability to gain the upper hand in, for example, cut-off times, deadlines and election windows of local corporate actions. They very often have superior relationships with local infrastructure, be that exchanges, CCPs or central depositories. This has the advantage that you can work right up until the market closes in an effective and problem-solving manner. Whilst much of this is of a non-contractual nature and is usually on a "best efforts basis", having local people familiar with the market, clients' activity and behavioural patterns, coupled with sound technical knowledge of what's possible and what's not, is a distinct advantage.

ISS: Are there any areas not covered by the above that you think we need to include in the discussion?

Andy Duffin: The requirement for a client to have an exit plan from its existing sub-custodian is increasingly being debated in the industry. Whether this is called a contingency provider, back-up provider or secondary provider the real issue is having an exit strategy. The need for an exit plan is for me not in question as there have been numerous examples in recent times where, not through choice, clients have been forced to move from one sub-custodian to another. Today, the selection process and service demands of a sub-custodian are broadly the same for most clients. However, when it comes to appointing a contingency provider there is no commonality in the selection process and the required services and level of engagement differ greatly from one client to the next. There is also no common industry view upon what a service provider should deliver in terms of service and capacity. There is also limited interaction between sub-custodians regarding how they would plan in advance to efficiently deliver a client's exit strategy. The industry needs to work together to tackle these points and address this current area of risk.

Jessica Hynes: I think it is important to point out that the seven major custodians are all globally systemic important banks (G-SIBs), and that in terms of custody and sub-custody, they are all networked into one another. The majority of the world's assets are thus looked after by tightly regulated and well capitalised institutions. Future growth will be driven, broadly speaking, by market growth, but if markets are thin no one will go into them as there is no business case.