

Sub-custodians adapt to meet global demand

A panel of industry experts from BNP Paribas Securities Services, ING, RBC Dexia Investor Services and SEB convened in Toronto to discuss the sub-custody business, where the future lies and whether pricing structures need to be revisited



The Panel



Alan Cameron is head of development for broker-dealers and investment banks at **BNP Paribas Securities Services**. He has worked in custody and clearing for more than 25 years, gaining extensive experience in product and relationship management. He holds a Master of Arts in Economic History from the University of Edinburgh and is an associate member of the Institute of Bankers in Scotland.



Lilla Juranyi is global head, investor services, at **ING** and has been in the business for more than 15 years. ING provides custody and sub-custody services in Bulgaria, the Czech Republic, Hungary, Poland, Romania, Russia, the Slovak Republic and Ukraine.



Ulf Noren is global head of sub-custody at **SEB**, having worked in both global custody and sub-custody for more than 25 years. SEB's sub-custody venture is now active in 10 markets: Denmark, Estonia, Finland, Germany, Latvia, Lithuania, Norway, Sweden, Russia and Ukraine. Noren is involved in several industry initiatives and also promotes industry initiatives in such social media as the Benche and Twitter.



Tim Wood is head of global network management for **RBC Dexia Investor Services**. He is responsible for the management of the worldwide sub-custody network, providing access to more than 90 markets. He is responsible for operational performance, which manages and reports on the activities of all operations functions globally. Wood joined RBC Dexia's predecessor business in 2002 and was head of client services and head of operations and fund services until 2009. He has worked in the industry for more than 20 years, previously holding senior client-focused roles within investment management companies.

Custody Risk: Is the distinction between a sub-custodian and a global custodian still a meaningful one?

Ulf Noren, SEB: Yes, it is still meaningful. You see the activities of both entities touching on each other's primary areas of responsibility, but I still think the distinction is there, and it will remain a distinction for quite some time.

Lilla Juranyi, ING: I fully agree. I think sub-custodians and global custodians try to stay out of each other's business as much as they are able to. Global custodians do not want to be sub-custodians, and sub-custodians do not want to be global custodians. But there are some exceptions, for example, the local investors in my area, the central European countries, require that we service them not only on the local market, but through cross-border investments. This limited service would not make me a global custodian.

Tim Wood, RBC Dexia Investor Services: Yes, it is still meaningful. We regard our relationship with our sub-custodians as an extension of our own business and, as such, demand an identical level of service from the sub-custodian network as we do from our own offices and internal business units.

We place a strong emphasis on the selection, assessment and review of our network to ensure the appropriate performance of each sub-custodian and the ongoing protection of our client assets. It provides the best of both worlds: the sub-custodians bring their local market expertise, and the global custodians bring their critical mass and international strengths.

Alan Cameron, BNP Paribas Securities Services: I disagree entirely. We have gone past the stage where we define ourselves by the products that we are providing to clients. What we are doing in our industry is defining our business models by the client segments that we service. And, for any one of these client segments, it's about packaging a number of different products together to satisfy the clients' demands. Nowadays, very few clients need one single thing. They tend to need a little bit of this, some of that and a few other services on top. So the client may be given some direct custody, some global custody, some stock lending and some third-party clearing. It's about being able to package all of these products together for the specific client demands. So, to define your business by the products is perhaps a bit old fashioned.

Lilla Juranyi: You are right, we have to segment ourselves according to the clients, and that is exactly what I am referring to when I say we are supporting local clients with cross-border investments. However, this broader service does not elevate me to the position of a global custodian.

Ulf Noren: We provide services to cross-border financial institutions in a defined sense of markets, where we are acting as their prolonged arm in that market. We do this with a large variety of services, very much individualised for each of the clients, but what we are doing is providing sub-custody.

Custody Risk: Are single-market players a dying breed?

Tim Wood: The trend by some banks towards direct sub-custody will seriously impact the profitability of many single-market sub-custodians.



And, in Europe, Target2-Securities (T2S) will be a major factor in single-market sub-custodians realising their product has reached its sell-by date.

Also, if a global custodian has a network of multi-market sub-custodians, then there are advantages including the reduction in risk, consistency of relationship management, service level agreements and legal agreements, as well as the ability to leverage fees to have a domino effect on additional markets.

Alan Cameron: Are there any left? Those that are left will struggle to stay in the game because of the huge investment in technology that is required nowadays, and because clients don't want to maintain as many relationships as they did in the past. We don't often think about the fact it is expensive for clients to maintain relationships as well as it is for us to service our clients. And the feeling I get is that clients are trying to cut down the number of providers they have to a reasonable number. So I am afraid the die is cast for the single-market custodians.

Lilla Juranyi: I fully agree. There is no future for them. In some smaller markets there may be the opportunity for a few local service providers that can offer services to very special local clients. But these services could be something very simple – a plain vanilla service. They certainly cannot be considered as competitors to the multi-market providers or the global providers.

Ulf Noren: I also agree. It is going to happen all over Europe, with the possible exception of the UK and Switzerland. These are both markets that are big enough to sustain single-market suppliers. Europe, in total, will drop to fewer than 20 suppliers, and that is a generous estimate. On a bad day, I would say it is considerably fewer than that.

I would also like to point out that, although consensus is that single-market players will not survive, it does not come from the fact that they are doing a bad job. In my region, we have examples like DnB Nor, which is an absolutely brilliant sub-custodian, but the business model is not in correspondence with the purchasing pattern from clients that want to contract the network.

Custody Risk: The decision earlier this year by JP Morgan to insource some of its sub-custody has sparked debate in the industry. Does this signify a change in relationship between global custodians and sub-custodians? Has the gentlemen's agreement between sub-custodians and global custodians to stay out of each other's business closed down?

Tim Wood: It is just another approach, strategy and challenge for the relationship between the two, rather like T2S, which will see a final round of consolidation among the remaining sub-custodians.

I also believe there has been a shift in thinking, with most of us revisiting traditional strategies to tackle the enormous amount of regulatory changes and challenges. For example, it is RBC Dexia's current strategy to appoint a single, qualifying sub-custodian bank in each market, which balances our core values of risk, service, creditworthiness and cost to ensure best in class is offered to protect our clients' assets. In countries where RBC Dexia offers a potential local solution, it would only be considered during any market review on the condition that they met certain mandatory criteria.

These conditions will include, but not be limited to, the size of assets; links to the market infrastructure; meeting of the minimum appointment criteria locally to prove there is a long-term commitment of the business; maintaining, where required, a physical presence; offering a competitive service solution; and being able to service both local and global custodian businesses.

Alan Cameron: There never was a gentlemen's agreement between global custodians and sub-custodians to stay out of each other's business as far as I'm aware. Most of the big global custodians provide domestic custody in their home market in the first place. But JP Morgan's decision is very interesting for the industry. It will be interesting to see if other global custodians do the same. I suspect some of them would think about it because of the regulatory confusion and the pressure that is put on them to secure the full value chain for their clients.

Lilla Juranyi: This is definitely a strategic decision by JP Morgan, but



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we'll have to wait and see what this will mean for the whole market. They are entering into a market that is already very competitive. They will not be competing with only the existing local agent banks, but they will also compete with the new recently upcoming local banks that are also quite aggressive.

Ulf Noren: What JP Morgan is doing and what any global custodian is doing with a similar move is to set up the sub-custody business line, as well as a direct custody business line. It is interesting to see what is driving that. There are risk and mitigation concerns that drive it primarily, but it doesn't change the relationship we all have. We are all friends, all competitors. The more competition you get, the better you become yourself. Just because you are a big global brand coming in, doesn't automatically mean you win and grab all the business. The competitive situation is tough in most sub-custody markets, so let's see. I always welcome all competition, it makes you better, and the day it doesn't make you better is the day you stop doing it. And I don't think we're there yet.

Lilla Juranyi: To a certain extent, it definitely changes the relationship. I'm a custodian and so is JP Morgan and, if they are coming to the market, our relationship will be different, at least in that market. But I do not think our general relationship will change because we service them in several other markets. What we have to understand is they made their strategy decision and we have to accept it.

Alan Cameron: Regarding the relationship, we're already used to living in a fairly complex world where we compete with our clients sometimes, and sometimes we are clients of our clients. So I don't think the relationship has fundamentally changed. It's something we have all grown used to over the years. And, for the industry on the whole, it's a good thing to see a bank with the reputation, expertise and capabilities of JP Morgan joining it. It is much more concerning seeing banks leave.

Ulf Noren: I echo the fact that I'd much rather welcome someone like JP Morgan, which has all the understanding capabilities of the business. I welcome this far more than the competition from monopoly central securities depositories that Europe's politicians are trying to push on to us.

Custody Risk: Let's discuss pricing. Presumably one of the biggest discussions sub-custodians have with their global custodians and managers is about 'how cheap can you make it?'. Are you seeing changes in attitudes towards what global custodians are now willing to pay for? For example, are global custodians now willing to pay for value-added services?

Alan Cameron: This can be looked at in two different ways: one, what people are conceptually willing to pay for; and two, what they are practically willing to pay for. Conceptually, people are very interested in stripping out bills and having fees for liquidity, fees for different forms of corporate actions, fees for settlements and even fees for settlements not happening. However, in practice, it is actually very hard to get this done on a bilateral basis because you have to get into a situation where a sub-custodian can provide a bill and the client receiving it can reconcile it. There's no real industry standard yet of what should be in a bundled bill. So, although some sub-custodians would like to offer that to clients, an across-the-industry agreement is missing to make it viable.

Lilla Juranyi: The debate is about fee restructuring and whether it should be bundled or unbundled. Unbundled fees should be set up, and that will force the whole industry to come up with new structural fees. At the moment, the question is simple: should fees be pressed further down? Personally, I would say there are always a few revision discussions that could be had. However, in the past three to five years, the fees have been significantly lowered, so much so that they cannot really get much lower, at least in the complex emerging markets.

What I am seeing is a different trend, and this is that customers are often requesting to see more details about the building of the fees – what is included and how transparently I can report it to them? This is a little bit tricky because, if I make everything transparent, what will be the level of this transparency? A difficult part of a more transparent fee structure is that, quite often, the local market fee is charged in a different way to how we are charging it to our clients. This is a very big issue that everyone needs to monitor carefully. For example, if a local market fee is charged on a daily average basis, what is the fee, what is the price and what is added for the daily average fee calculation? And, if a local custodian or a sub-custodian is preparing the bill, will it be using exactly the same fee calculation methodology of what is on that particular market? Or will it follow the international standard market fee?

Tim Wood: With more demand from clients and regulators, and more complex operational challenges, do sub-custodians really have their pricing structures positioned appropriately? The future may well see a risk-based pricing model taking into account the resources and expertise required to manage the additional requirements and associated liabilities.

Ulf Noren: As long as there is short competition, the total bill will continue to go down. This will continue to happen, especially on the transaction-fee side, which is becoming more and more transparent because of T2S. Whether T2S happens or doesn't happen, the focus on it has been so great that the professional buyers (and we are mainly dealing with professional buyers) have a fairly good idea of how they want their business to develop in five, six or seven years' time. They say, 'I want to reap the benefits and I want to reap those benefits now'. It will lead, for many client segments, to a separation of settlement and value-added services. And that means the settlement element is truly becoming a worrying business case. And so, as a sub-custodian, you have to have a fairly good survival case and have an idea of where you are going. And you also need to re-engineer your operations as efficiently as possible, as cheaply as possible and as error-free as possible.

Sub-custodians need to re-engineer their business models to provide more clients. They need to do this considerably more than they do today. Sub-custodians have to engage much deeper into the client business; they have to be proactive when it comes to reducing risk elements; and they have to make sure the buyer is sleeping soundly at night. Sub-custodians need to become much more professional in many areas; they need to invest more money into value-added services. Gone are the days when it was OK to think that providing corporate action services was value added. Sub-custodians need to evolve. They need to seek a higher quality of staff, of balance sheet optimisation, of



Ulf Noren

collateral management and of risk reducing activities. This is actually providing something that is value added, not only as two words in a headline, but actually perceived by the client as value added. If you get that, then I think you can charge for it.

Alan Cameron: I would also say that sub-custodians are in a tight spot selling into competitive markets with huge pressures on them. They are buying from monopolies where there's less pricing pressure, so the sub-custodians are in a very difficult position.

Custody Risk: Should liquidity be paid for?

Tim Wood: No, this should be part of the standard product offering intra-day credit facilities in a transparent way.

Lilla Juranyi: I disagree. I absolutely believe that liquidity is something where your capital has to be allocated, so it cannot be free. If you are offering facilities that are available for the client at any time, to any extent, then it's a cost for you. It should be paid. I do not think this is part of the service that would be required as free of charge. There are different elements, for example, whether it is intra-day liquidity or not. So, if you go into details, then it can be defined much better. But, in general, liquidity is an additional support to my clients and it should be funded in a way.

Alan Cameron: I would say it's important for custodians to be able to bill in a bundled fashion and in an unbundled fashion. There are some clients that will not want to get down to the level of measuring and reconciling anything, let alone liquidity, and that's fine. We should be able to bundle our pricing for them. However, there are clients that would be interested in measuring it and, for them, we should get into a position where we can measure it and charge for liquidity. But we sometimes also receive liquidity from clients.

Ulf Noren: I would say liquidity is and has been a key element in having a business overall. Liquidity is, to a great extent, already paid for. However, intra-day liquidity is not, and very few banks in Europe

have the methodology to do that. You need to get to that stage first and then it is a willingness to pay for it. Naturally you pay for all sorts of liquidity, though normally not for intra-day.

If I constructed my model so I could measure an account for intra-day liquidity in addition to a complete unbundled fee schedule, and I then went out to my clients and said, 'at any given second I am now able to offer a true reflection to the activities you have had in my market and I'm going to charge you for it', then I would probably ruin my business. It has to be a move that is co-ordinated with the whole industry. The market has to come to a point where there is a fairly broad and strong opinion that this is something that is done.

Custody Risk: Are sub-custodians willing to move from a transaction-based pricing model to a risk-based pricing model?

Tim Wood: As I mentioned before, the future may well see a risk-based pricing model. Credit and regulatory challenges remain high on everyone's agendas, but they come at a price. Who should pay for the extra time and resources involved? Risk-based and regulatory pricing models will start to emerge.

Alan Cameron: There is a willingness to look at moving from transaction pricing and unbundling credit, liquidity and risk. However, each one of them is measured differently by different financial institutions, so it would be very hard to come to a consensus about how to do this. Again, the theory is good but the practice is somewhat harder. Corporate actions would be an interesting area to think about introducing risk-based billing because that's where a lot of risk in our business lies. And we need to address whether we should start charging differently for more complicated corporate actions. Things like that I could see happening.

Lilla Juranyi: Risk is an important component for both a sub-custodian and a global custodian. We are all facing increasing risk and compliance requirements, and there is definitely a cost for that. You have to pay much more for just hiring people who are able to focus solely on mitigating risk and ensuring compliance. I'm ready to make this move, but I have to understand what level of costs I will have to swallow myself and what level of costs I can pass on to clients. The industry is still far from coming to a common understanding of what risks should be charged for and what should not – not only the risks, but the mitigation of the risks.

If the whole industry comes to a common agreement, then sooner or later discussions will start. It may not be in the form of a new risk-type fee, but it may lead us through to some kinds of new fees. And, hopefully, the clients will also have greater understanding and appreciation of the fact we are making big investments into risk mitigation and it is for their benefit.

Ulf Noren: There is willingness to look at alternative ways of charging, but finding a common answer will be difficult. If you take, for example, a high-frequency trader that conducts zillions of trades in a month, in one of our markets, we have the possibility to lock in the trade activity. We can pace and control our settlement process based on the availability of money or sufficient lines and on the availability of securities. They have no positions held in any respect and don't do any corporate protections. That is a fairly low-risk activity, but all our underlying



Tim Wood

charges are based on transactions, and we are only able to charge a transaction-based cost.

In another market, we as sub-custodians assume all the clients' risks in acting toward the infrastructure, then I certainly would be ready to give up the transaction-based charge in a day, if I could get something out of the risk exposure that we have. And, looking at our markets, we assume considerable risk on the whole for my clients just by being there in many different areas. It's extremely hard to define what you do charge for.

We need to look at alternative ways of charging – capping fees, for example. Or charging for a reasonable variety of activity level could be another way. It will be a long way until we are able to charge completely on risk-based levels because it's too complicated.

Alan Cameron: Although it is logical to argue that our fees should reflect where our cost base is, it is equally logical for our fees to reflect how our clients are making their money. And if our clients are charging their clients on a simple basis-point manner, then it is very hard to get them to break that model in the fees that they are paying out. So everything that we are saying is true and good, but you would need to see changes at different points through the entire industry if it was really to become practical. People are quite willing to pay charges as long as they mirror what they are charging themselves.

Lilla Juranyi: Yes I definitely agree. It's important to ensure that fees are transparent and clients know what they are being charged for. We need to refer to the market fees because, if the market fee is something different, if there is no market fee or a very complex market fee, then we also run the risk of assuming more costs to ourselves. At the same time, there could be the possibility of overcharging or incorrectly charging a client – although the latter is a lot less likely. Overall, this is a very complex subject. Fee transparency and changing fee structures between global custodians and sub-custodians may be somewhat easier to tackle. But, when we regard the end-investors and the market, it will be a little bit more difficult to make changes.