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Evaluating, Selecting And Monitoring Global Custodians

By: Ross Whitehill

In the UK and European markets, the task of evaluating, selecting, and monitoring **global custodians** and related service providers is increasingly being enshrined in **legislation** and best market practice guidelines. Portfolio sizes and the focus on the individual's interest as a beneficial owner in the portfolio are also providing the momentum for better practice around reviews.

While the Canadian market does not have **legislation** similar to the UK and European markets, there are guidelines being introduced by the various regulatory and industry associations in regards to business process outsourcing. The Office of the Superintendent of Financial Institutions introduced the B10 – Business Process Outsourcing Guideline for Insurance Companies, the Ontario Securities Commission is working with its international counterpart and the Canadian Association of **Pension** Supervisory Authorities (CAPSA) to introduce guidelines that are in line with the Financial Services Act in the UK. The underlying principles are focussed on best market practice, benchmarking, and monitoring.

Experience in the last 12 to 18 months reveals that institutional investors are concerning themselves more and more with the business of ensuring that their current arrangements are in line with best market practices. The stimulation for this has come from publicity surrounding many high profile changes of custodian and the service, risk minimization, and financial benefits that have accrued to the investor or fund as a result of the review.

The industry is being drawn to three distinct levels of provider evaluation and this reflects the importance of the various stages in the life cycle of a relationship with a provider.

These reviews of the current arrangements take the form of a clear 'health check' that examines three critical elements of a relationship with a provider:

- service level agreement
- custody and related services agreements
- fees and commercial arrangements

Service Level Agreement

The first step is to look at the service level agreement (SLA) in order to understand what services are being provided by the custodian. Typically, the SLA is not very well constructed and takes the form of a high level description of what services are available, but does not address the commitments that are required of both parties. Increasingly, investors are requiring that their SLA addresses all aspects of the service, from consistency of relationship management staff through to disaster recovery plans.

Custody & Related Services Agreement(s)

Next, the main agreement gives a full picture as to the asset safety and risk minimization provisions in the relationship and the extent to which the custodian bank/service provider will take responsibility for losses and protect the client from risks in the markets. Often the contracts that have been signed present a variety of risk evasive clauses and many agreements have protections in favour of the service provider. When challenged, the providers will generally say that there is never likely to be a situation in which such clauses would be invoked and, therefore, there is no cause for concern. Investors can form their own conclusions.

Fees and Commercial Arrangements

This is generally where the real shock comes as institutions find that they have been disadvantaged by the fee and commercial arrangements in place. Normally, the ancillary cost items such as interest spreads, F/X margins, and securities lending splits (pre/post transaction costs) have been ignored in the past and when taken into consideration make a significant difference to the total cost of the custodian relationship. This is validated by the custodian providers many of whom will say that around 50 per cent of their revenues come from non-headline fees.

Increasingly the findings from 'health checks' are so disturbing that they trigger a full review of the custodial and related services arrangements. While the incumbent suppliers usually make strong competitive proposals to retain the business, the client relationship is sometimes damaged beyond reasonable repair.

Further, competitor custodians try to add to the inducement to move by offering fee reductions, contributions, and fee rebates to facilitate the transition away from the incumbent. Commitments to provide support staff during the transition and beyond can make a persuasive argument against staying with the incumbent.

While reviews can be time-consuming and costly, the pay back in terms of service improvements, access to new technology, reduced risk, and increased asset safety provisions as well as clear commercial benefits can make a compelling case for taking a mandate to market. Investors are also saying that it has a salutary effect on custodians as it shows that the business is not necessarily with the custodian forever.

In order to deliver maximum benefit, the RFP review is best when highly structured and clear on what the key buying criteria for the investor might be. Our view is that the RFP review should be structured as follows (See Chart 1).

Custodian Benchmarking

Following the appointment and transition of assets, it is obviously important to maintain an ongoing review of custodian performance against best market practices and, more particularly, the SLA. Many investors neglect this element of the relationship and allow the custodian to provide quarterly or bi-annual reports.

Benchmarking service against the SLA is a clear-cut activity, but gathering universe data to ensure that service levels do not slip below standards generally accepted in the market is quite different. Further, regulatory interest in benchmarking, while not prescriptive, would suggest that structured ongoing comparison with the market is seen as best market practice.

One approach is to gather data from custodians across a range of service quality indicators, put them into a comparative database, and analyze the results. Doing so clearly shows how a given custodian's service for a client compares with other custodians' service for other similar types of clients. It is important to recognize that this benchmarking will often throw up deficiencies in the clients' operations and for this reason custodians generally welcome being compared with other providers because it provides valuable benchmark tools for them to:

- analyze their own strengths and weaknesses
- determine the problems that are client driven and seek to resolve them

FX Benchmarking

In addition to operational benchmarking, foreign exchange benchmarking can be particularly relevant for small to medium sized funds that may be using their custodian for a large percentage of their foreign exchange execution.

Record Currency Management, who has been providing foreign exchange benchmarking since 1983, has found that a tiny minority of funds has currency trades being executed in an effective manner overall. The benchmarking component examines foreign exchange transactions executed by the custodian. These transactions are compared against a database. Foreign exchange benchmarking will identify the effectiveness or otherwise of the currency execution the fund is receiving from its custodian.

Securities Lending Benchmarking

Securities lending performance analysis is another area to examine. This will enable pension funds, asset managers, and other institutional investors who have mandated their respective custodians to carry out securities lending on their behalf, to monitor their performance, and to assess the risks associated with the activity.

As portfolio values increase and custodian competition for mandates accelerates, investors are well advised to put in place sound evaluation, selection, and monitoring tools.

The cost of implementing such tools and processes can be such that CFO approvals are required, but the costs of not doing so can be such that the CFO's job retention could be reasonably challenged by any reasonably informed CEO or auditor. ■

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