

# On the move

Although rarely viewed as a glamorous sector, direct custody and clearing is transforming itself to become a vibrant and increasingly important business, writes ANDREW GELB

Direct custody and clearing has long played an integral role in the international capital markets by providing the local market backbone for securities settlement and asset servicing. For institutional investors and their global custodians, it is a critical element in the global custody supply chain, and for broker-dealers it has become the most effective way to expand global market access.

Sometimes depicted as a “boring” infrastructure business, direct custody and clearing has become anything but. The custody and clearing landscape has been transformed by the wave of globalisation, growth, innovation and risk taking that has characterised the global securities markets over the last several years. These developments have spawned a remarkable wave of change across the custody landscape, not only in terms of capabilities and services required

but also in the role custodians play across market participants.

Without question, the capital markets have become truly global, characterised by massive investment

flows, both to and from, mature and emerging markets. As evidence, during the last five years, the US market has gone from almost one half of global equity market capitalisation to just over one third. As capital has gone global, many emerging markets are now becoming significant net capital exporters themselves.

## Responding to needs

Against this backdrop, direct custodians must respond to the expanding needs of clients for services not only in the traditional emerging markets but also into the “frontier” or newly emerging markets that have yet to develop into major investment centres. Importantly, custodians must also be able to integrate services effectively across markets to provide clients with a globally consistent, but locally focused capability that can facilitate successful transfer and provide economic benefit. Providing this global/local offering will continue to be a point of focus in the industry going forward and remains a major challenge due to the market-specific nature of the direct custody and clearing business.

At Citi, we have responded to this globalisation trend by opening seven markets in the last two years, bringing our global proprietary network to an industry-leading 51 markets. Having recently opened Morocco and Kazakhstan, we have plans to expand further this year into the Ukraine, Dubai, and Nigeria among others.

It is no secret that recent growth in the

securities markets has been dramatic. In the equities markets alone, global market capitalisation has grown at over 20 per cent a year since 2002, with Asian markets up approximately 33 per cent annually during this period. Transaction volumes have shown a similar trajectory with sharp worldwide growth last year, especially for on-exchange trading activity in Europe. No discussion of market growth would be complete without mentioning the rise of hedge funds and their increasing influence on the global capital markets. Hedge fund assets have been variously reported to have surged to approximately \$3trn. While this represents just a fraction of global securities assets, hedge funds have been estimated to account for as much as a quarter of trading in global major markets.

To support the explosive growth in market activity, custodians must continuously invest in capacity and technology to support increasing volumes and numbers of client positions. Combined with the inherent local market complexity borne by custom systems requirements and market interfaces, these infrastructure requirements are substantial and ongoing. However, they remain at the core of the direct custody and clearing service offering. While the entire industry faces this challenge, Citi in particular has embarked upon a multi-year effort to enhance our global infrastructure and provide clients with the resulting benefits that accrue from growth and scale.

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## Globalisation

Globalisation and growth have been coupled with a period of innovation rarely seen in the securities industry. Products have proliferated at a rapid pace. Investors have introduced complex strategies like algorithmic trading, programme trading, hedging, and arbitrage. The derivatives markets are becoming more intertwined with securities and the once distant vision of cross-margining is beginning to hold some promise of becoming reality. From the market standpoint, there has been a sharp increase in the cross-listing of issues, and numerous exchange links, partnerships and mergers between bourses have been consummated. Alternative markets have begun to pepper the trading landscape, with participation and sponsorship from leading capital markets participants. These changes have been truly extraordinary.

From the custodian standpoint, these trends have led to an increased emphasis on tailored solutions across client segments, along with an imperative to work closely with market participants to facilitate change. There is no doubt that the proverbial bar has been raised, as client expectations now extend well beyond the core offering of settlements and safekeeping into an array of value added services including operational integration across various aspects of the client back office. Not only must custodians be prepared to support clients across instruments, markets, and strategies, but there is an increasing need to provide collateral management and treasury solutions to enhance efficiency and maximise yield across markets. Direct custodians have also taken a much larger part in representing clients on initiatives promoting efficiency, safety, transparency and competition in the securities processing markets.

## Forefront of development

At Citi, we have been playing a large role in this space in partnership with our clients. In particular, to support the growth in derivatives activity, we have introduced exchange derivatives clearing in several markets, with plans to extend this capability further. We have also been at the forefront of developments that provide clients with more options and flexibility in their



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operational models, including the account operator, third party clearing and exchange traded services.

Last year, the Turquoise consortium appointed EuroCCP to handle clearing for a new alternative trading platform, and EuroCCP selected Citi to provide pan-European settlements. This project could prove a significant market innovation and is an illustration of a custodian playing a role in the capital markets arena supporting both clients and infrastructures. We have also launched an Investment and Funding Solutions group to help clients with cross-product, cross-currency efficiency, which draws upon a set of capabilities outside our traditional custody and clearing business.

There is no doubt that risk management has become a large and well chronicled story on the capital markets stage. However, this is a major subject in the custody business as well, amplified by the dramatic increase in volumes and values alongside persistent processing and operational complexity. While credit risk is self-explanatory and well understood, custodians still have significant exposure throughout the settlement process. Liquidity risk, sometimes less understood, is a major consideration considering the role of custodians in providing temporary funding to support client trading activity.

Operational risk is ever-present in the business, and the challenge has been amplified by hedge funds and other market players whose trading strategies result in rising demands for complex asset servicing functions.

While market and provider-led developments have mitigated these factors to some extent, significant exposure still remains for custodians. One could argue that the traditional pricing paradigm in the custody business does not fully account for the newer flavours of risk, particularly in asset servicing. The industry has begun experimenting with unbundled pricing to better align cost to risk in the area of asset servicing, and Citi has introduced this concept in selected markets. However, this will continue to be a significant point of emphasis for all custodians in the industry.

In summary, the direct custody and clearing business of today is strikingly different from the traditional, somewhat plain vanilla industry that it was in years past. As the capital markets continue to advance, so will our role and complexion. Across the industry, we look forward to shaping this future. ■

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