The investment industry, and its associated supply chain, are at an inflection point where the future begins to look progressively different from the past. While there are many factors that underpin this change, two stand out: the quest for alpha and the growing demand for new products and strategies, including the search for absolute returns, from rapidly retiring baby boomers.

In the aftermath of the dot-com bubble and the market timing issues in the U.S., regulators across the world will continue to aggressively look to harmonize markets and protect the retail investor.

The effects of these trends resonate across the entire value chain from issuers requiring support for CDOs or execution of LDI strategies, to investments in an ever-expanding set of markets with increasingly sophisticated instruments (e.g. complex derivatives). Thus, as the front office becomes more complex so will the mid- and back-office. The winners in this game will be those who can find creative remedies to these needs and are able to turn the traditional axiom on its head by doing more for less.

Several tightly interconnected, highly interrelated factors are driving and shaping the future of custody, and more broadly, the investment servicing industry:

Globalization
Globalization has traditionally been understood to be the opening of new emerging markets in the search for incremental returns. No doubt that trend will continue - but interestingly, emerging market countries such as India and China will become sources for investment capital as their insurance companies and pension funds mature. New investment vehicles, products and distribution capabilities will be required for locally domiciled global products. Custodians will not only have to provide clearance, settlement and safekeeping capabilities in many more markets than ever before, but will also have to supplement these services with on-the-ground support so that their clients can quickly and efficiently tap into these local and intra-regional flows.

Regulation
In the aftermath of the dot-com bubble and the market timing issues in the U.S., regulators across the world will continue to aggressively look to harmonize markets and protect the retail investor.

Chart 1: Product Growth

MiFID, for example, will increase transparency requirements and enforce best execution. These demands can only be met with very robust, tightly controlled processes and sophisticated technology platforms. As a result, custodians may be expected to become ‘keepers’ of data as well as the ‘keepers’ of assets. In addition, even though custody is not a fiduciary activity, clients will increasingly expect their custodian to provide some level of oversight irrespective of the contractual relationship. By effectively leveraging their custodian, clients will be able to meet their twin objectives of regulatory compliance and internal cost management. The effective custodian will go a step further by being a change agent that encourages emerging market regulators to create and approve regulations that enable increased transparency, securities lending and simplified tax regimes - all prerequisites for the efficient flow of capital.

**Over the last 10 years there has been a tremendous expansion in strategies adopted by investors as well as the use of complex instruments to support them. What makes this even more challenging is the fact that many of these instruments are traded OTC instead of on exchange.**

**Increasing Sophistication**

Over the last 10 years there has been a tremendous expansion in strategies adopted by investors as well as the use of complex instruments to support them. What makes this even more challenging is the fact that many of these instruments are traded OTC instead of on exchange. This product proliferation is illustrated in Chart 1.

As a result, mid- and back-office services for investors require more creative and tailored solutions. For instance, the trade life cycle of a credit default swap is profoundly more complicated than that of a bond. This complexity needs new skills, technologies and operating risk management tools.

**Asset Servicing**

Asset servicing (corporate actions, dividends, proxy and tax) has always been a significant issue for asset managers. However, with the emergence of hedge funds and with broker/dealers now holding custody positions for their prime brokers, there has been a dramatic increase in service requirements and overall volumes. At the same time, many of the industry processes have not evolved and remain highly manual. Until there is industry-wide change, custodians must manage increased risk while controlling losses. The result may be changes to the present paradigm for pricing custody.

**Client Service/Tailored Solutions**

Custody has to be viewed as a component of a larger suite of investment services capabilities. Because one size does not fit all, solutions need to be tailored according to client needs and growth strategies. For instance, in Europe, as settlements have become more of a commodity, certain clients prefer to perform self-clearing and settlement but outsource their asset servicing functions. Other clients outsource all of their mid- and back-office activities in order to focus on their core competencies of asset gathering, asset management and/or trading.

All of these factors point towards a very different future for the custody business. The relationship between clients and their custodians is already transforming from ‘client-vendor’ to ‘strategic partnership.’ Naturally, this evolution will unlock significant value across the investment industry.

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