Managing custody risk

Investors need to recognise the risks that may be lurking in their custody relationships.

The European Central Bank’s move to inject more than €500 billion of net new liquidity into Europe’s banks through its Long-Term Refinancing Operations has had a positive impact on the European banking system. But few observers are ready to conclude that either this or the recent Greek bail-out will prove a once-for-all panacea. Sovereign debt pressures remain – and with them concerns over the robustness of some bank balance sheets.

The message for investors is that there are still a host of risks to weigh in managing their banking and, in particular, their custody relationships. Those risks include:

- **Counterparty risk** - particularly sub-custodian exposure
- **Transparency and control risks** - focused on asset segregation
- **Regulatory risk** - including depositary risk

**Counterparty risk**

With the eurozone crisis, sub-custodian risk has become a live issue. The due diligence required to monitor the health of a third-party agent bank has taken on an added dimension. Clearly, the greater the number of agent banks employed in a sub-custody network, the bigger the task – and the risks involved.

Liquidity and balance sheet strength are only two of the measures. Capacity is also important. Clients require timely information in extreme as well as normal conditions. Sub-custodians must have the technology, processes and qualified people to handle any eventuality in their market. In 2008, many institutions found themselves under-resourced. As the number of third-party agents increases, so do the management and control challenges.
There are other operational issues, too. ‘Global custodians reliant on third-party sub-custodians tend to use SWIFT for their reconciliations’, says Richard Ernesti, Managing Director, Global Head of Investors for Client and Sales Management, Citi Transaction Services: ‘Where a custodian is using its own proprietary network linked by a common custody platform and systems set, reconciliation is a simple matter of data comparison. The process is cleaner, faster and throws up fewer exceptions.’

Key risk issues international investors are considering:

- What proportion of the assets are held by third-party agents
- How easy is it to monitor those agents’ financial standing and performance?
- Are they branches of international banks?
- Are there parent guarantees in place where applicable?

Transparency and control risks

The MF Global affair has once again served to drive home the importance of asset segregation. To be fully effective, client assets must be ring-fenced not only at the global but also at the local custody levels and, where possible, at the depositary level too. Segregation should be supported by daily automated reconciliation at sub-custodian and/or depositary level.

A common technology platform throughout the network is an important contributor to transparency. ‘It allows the client to look through to the local market, ensuring not only full transparency but also real-time reporting’ says Kevin Lui, Director, Global Custody, Citi Transaction Services. ‘And if the worst ever happened, the same transparency would be available to an administrator, making it much easier to identify individual client assets,’ he points out.

Risks currently top of mind are:

- Are your assets segregated at every level?
- Is there sufficient transparency to look through to the local market and identify your assets?
- Are efficient controls in place such as daily automated reconciliations?

Regulatory risk

Investors pinning their hopes on a delay to the planned shift to central clearing for most OTC derivatives (the product of the Dodd-Frank act in the US, EMIR in Europe and parallel initiatives in Asia) look likely to be disappointed. There is now real urgency to putting appropriate clearing and collateral management processes in place. While many asset managers still examining their options they will need a custodian with the flexibility to provide either an end-to-end solution or a modular approach to plug specific gaps.

In Europe, the Alternative Investment Fund Managers Directive (AIFMD) imposes new responsibilities and liabilities on depositaries. These are likely to be mirrored in UCITS V. Despite the much increased liability they will face in the event of any loss of assets, many global custodians will be reliant on their third-party agent banks to perform these additional fiduciary duties.

The latest European Commission draft of the supplementing rules of the AIFMD applies the strictest of liability tests on depositaries. In effect, the AIFMD as currently drafted would invert the burden of proof, obliging the depositary to make good any loss first and then prove it was not liable. To establish that proof, a depositary would have to show that:

- The loss was caused by an external event
- It was beyond reasonable control
- The consequences were unavoidable
- And the losses were incurred despite any efforts to the contrary

‘This new dynamic burden of proof fundamentally changes the business risk profile of what used to be a straight safe-keeping activity,’ says Natalie Westerbarkey, Director, Client Executive, Citi Transaction Services. Not only is the cost of custody in less developed markets likely to rise but investors need to know that their depositaries have deep pockets.
New reforms require managers to consider:

- How reliant their custodian is on third-party agents and their ability to take on fiduciary responsibilities?
- How robust their agent banks will be in the event of a crisis?

**Contingency custody**

Against this backdrop, investors are increasingly exploring contingency custody solutions that will allow them to move assets quickly to a new provider if they encounter a problem with an existing custodian or sub-custodian. Normally, the process of switching custody providers can take up to six months. But if the client and the provider agree a contingency framework in advance, that period can be cut to one month, one week or even one day.

A contingency agreement will start with a service definition that reflects the level of latency required, whether cold, warm or hot. For instance:

- **Cold contingency** – global custody service agreement (GCSA) and basic account structure in place; no active management until trigger event occurs
- **Warm contingency** – GCSA in place and account structure set up to cover all markets and currencies; defined lag between account/market changes at incumbent custodian and changes being made to new provider
- **Hot contingency** – GCSA and full account structure in place; concurrent and immediate account/market changes at both the incumbent and the new provider

The framework will include a notice period depending on the level of latency chosen, normal implementation (other than the transitioning of assets and flows) and agreed maintenance to cover service evolution as the client’s requirements change. The cost to the client depends on the level of latency required.

**Citi’s credentials**

With its unique proprietary network and unified technology set, Citi’s Global Custody operations offer investors the safeguards they need in the current environment. ‘We employ our own branch network to act as our sub-custodians in 60 markets,’ says Mr Iyer: ‘Holdings within Citi and the ICSDs account for around 97% of all client assets. With full operational control through our own branch network and a unified systems set, this makes the process many times simpler and safer.’

The advantages cited by Citi’s clients are our:

- Position as a single, strong counterparty who can monitor almost all of their assets
- Asset segregation services at both the global and local level on a clear, contractual basis
- Ability to look through the market and provide high levels of transparency
- Oversight and control provided by our proprietary branches - common systems allow us to monitor KPIs in detail and track performance and service delivery
- Subjection to SEC oversight on the engagement of third-party agents - requires the most rigorous due diligence, ongoing evaluation and annual rectification
- Provision of in-house depositary services (in accordance with AIFMD requirements) for added security and peace of mind

There is one other plus. As the largest custodian of cross-border assets, Citi engages with regulators and other market authorities to help shape new regulation at an early stage. Mr Ernesti notes, ‘That gives us a head start in being able to communicate and manage change for our clients.’
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