Custodian Banks Land In Dilemma

By: Roger Fishwick & Linda Bernard

The financial crisis has damaged the revenues, profits, share price, and reputation of banks of all kinds. And, it has left global custodian banks facing a particularly awkward dilemma – one largely of their own making.

The original attraction of the custody business to the management and shareholders of commercial banks was its annuity fee based revenue stream where investors paid them to safekeep and service their assets, rather than net interest margin on lending which is the normal commercial banking model. As well, the low level of capital consumption (because the assets belong to the investors they are held off the balance sheet) was another attraction.

Unfortunately, even fiduciary possession of assets presents bankers – whose business is built on using the property of their customers to generate profits for themselves – with a constant temptation. So, from the 1980s onwards, when the global custody business was invented, custodian bankers succumbed to it.

Fallen Dramatically

During this time, safekeeping fees fell dramatically. The fees dropped from around 20 basis points in the mid-1990s to less than one basis point today for Canadian custody, for example. What made this possible was, partly, the competition between the global custodians, despite the consolidation in the industry. In recent years, the providers, in their pursuit of economies of scale, have consolidated to the point where just four banks now look after three-quarters of the value of assets in global custody.

Part of the shrinkage in fees reflected increased productivity in the industry. Throughout the 1980s, there was the development of the market infrastructure with the introduction of central securities depositories and the immobilization or dematerialization of securities.

In more recent years, despite vast expenditure on technology and outsourcing of processing tasks to low cost jurisdictions such as India, the difficulty of integrating the clients, staff, and systems of a constant series of acquisitions has undermined efficiency. What enabled the global custodians to pare safekeeping fees over the last 10 years, while still increasing profitability year on year, was neither competition nor efficiency, but old-fashioned banking practices – namely, the lending of the assets of clients to third parties and benefiting from clients when they engaged in transactions. From the 1990s onwards, global custodians developed a model of business which entailed using the core services of safekeeping and asset-servicing as loss leaders to attract assets which could be used for fees in the securities lending markets and for spreads in the markets for cash and foreign exchange.

Unfortunately, it gave the global custodian banks with a revenue model geared to the amplitude of the economic cycle.

Shrunk Significantly

Earnings from cash depend on the margin between the price at which a bank

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funds itself and the price at which it can lend money in the marketplace. With short-term interest rates deliberately held at very low levels by central banks in many countries, that margin has shrunk significantly.

Revenue from foreign exchange trading, which likewise depends on the spreads between currency pairs as well as the volume of transactions, is down by more than a third in the same period.

But even this steep decline is eclipsed by the collapse of revenues from securities lending, which are down since the end of 2008 in excess of 70 per cent.

In retrospect, it is obvious that the apparently buoyant earnings of the global custodians in the run-up to the start of the crisis in 2007 were dependent on loose monetary conditions, positive rates of interest and rising equity markets, and the securities trading and investment, leverage, short-selling, and cross-currency transactional activity they stimulated. Today, even the fees earned from safekeeping, transaction processing, and asset-servicing are lacklustre, since the majority are not fixed or transaction-based, but ad valorem. Gearing revenues to market values sold to clients in the bull market as reasonable compensation for the risks being taken on their behalf, has not worked in the directionless markets of the last 10 years. Servicing fees still account for three-quarters of the revenues earned by the global custodians, but they have at best stood still in recent years. And if getting them back up again seems the obvious solution to the shrinkage of income from cash, foreign exchange, and securities lending, it is hard to implement in the tough economic conditions clients find themselves.

The majority of global custodians are reviewing their fee structures and schedules, as well as considering alternative ways of charging clients. All are caught between the benefits of missing a market upturn if they ditch ad valorem fees and the fear of a permanent stagnation of revenue if they do not charge clients properly for the services that they supply. At present, there are the first signs of banks daring to renegotiate fees. However, those global custodians that have attempted to unbundle and increase fees in competitive tender situations have found competitors are still willing to pursue the old model of virtually giving the core safekeeping services away in the expectation or hope of getting paid from ancillary earnings. This caution is understandable. Raising prices is harder than cutting them. A switch from riskier, cyclical rewards in the markets to a more reliable, but less exciting, fee income model might also lead to a re-rating of the business by staff as well as shareholders. But developments in the external environment mean that decisions on fee levels and structures cannot be postponed much longer.

Chief among them is the changing attitude of the institutional clients of the global custodians. Certain episodes in the crisis, notably the collapse of Lehman Brothers and the Madoff fraud, have taught them that asset safety cannot be taken for granted even at a major global custodian. Losses incurred on the reinvestment of cash collateral received in securities lending transactions (which were not indemnified by the lending agent) have alerted them to the boundaries of the indemnities offered by global custodians. The more diligent institutional investors now also understand that a relationship with a global custodian exposes their assets to a host of downstream risks, against which they are not indemnified by the global custodian. They want global custodians to absorb a higher proportion of these risks. However, the challenges faced by investors – which for pension funds include deficits inflated by poor investment performance and the low rates of interest applied to their liabilities – mean they are seeking lower fees, not higher ones from their custodian.

Dissimilar Pressure

Regulators are also exerting pressure. In a case now notorious throughout the custody industry, the French authorities insisted that a pair of global custodian banks make good losses incurred by three institutional investors in collective investment schemes for which they were depositories who invested via prime brokerage agreements with Lehman Brothers, even though the depositories played no part in the investment decisions. In other words, regulators are forcing global custodians to assume a higher level of risk at a time when the fees they charge are at an historic low and their ancillary revenues have yet to recover from the financial crisis.

Regulatory pressure is also seen in the new capital adequacy regime being put in place and the 'stress-testing' of banks. This has resulted in much higher capital ratios being required for the custodian banks than was historically the case.

Secular Changes

These secular changes in the marketplace, with the reduction in market based revenues and the implementation of significant new regulation, are why it is increasingly hard to see how the global custodians can avoid adapting their fee levels and structures to new realities. Instead, they have stuck to a strategy of cost reduction by consolidation and offshoring. By these means, they have elected to grow profitability by increasing scale and reducing cost. Now, squeezed from the top by institutional clients alerted by the crisis to custodial risk and by litigation to the hidden costs of custodial services, and from the bottom by an infrastructure of central securities depositories and central counter-party clearing houses trading at utility prices, global custodians face a significant challenge in persuading institutional investors that the services they offer are worth the fees they currently charge, let alone an increase in fees. **BPM**

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