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Custody investigation is a worrying development

Until recently, custodians knew they had a broken business model. Now they are finding that regulators believe they might have a disreputable one too.

In its business plan for 2013-14, the Financial Conduct Authority, the successor to the Financial Services Authority as UK financial regulator, is promising to investigate the possibility that custodian banks are exploiting their customers in securities lending, foreign exchange, transition management, cash and securities collateral management and derivatives clearing.

Certainly, the aftermath of the acute phase of the financial crisis in 2007-08 has exposed conflicts of interest in the modus operandi of the custodian banks.

Taking a share of the revenue from lending the securities of their clients on an undisclosed basis was one highlighted by the European Securities and Markets Authority in July last year, when it suggested funds return all revenues from securities lending to the investors taking the risk. In their final form, the Esma guidelines require funds to disclose details of how revenues are split. The Kay Review of UK equity markets also had a view, calling for all income from stock loans to be rebated to investors as well as disclosed to them.

Conflict of interest

A second alleged conflict of interest, in foreign exchange execution, became the subject of high-profile litigation.

In October 2009, Jerry Brown, then California Attorney General, sued State Street for repayment of more than \$200m for allegedly over-charging two state pension funds in foreign exchange transactions. State Street said in a Securities and Exchange Commission filing in March this year that the case is still in a discovery phase. In 2011, Virginia Attorney General Ken Cuccinelli sued BNY Mellon on similar grounds. According to BNY Mellon's annual report for 2012, the court dismissed the lawsuit with prejudice by agreement of the parties.

The same year, the New York Attorney General sued the same bank also on claims relating to foreign exchange dealings, a case which is still ongoing.

In a third area, transition management, custodians are alleged to have embraced the most egregious conflict of interest of all: acting simultaneously as agent (taking a management fee for completing the transition or commissions on trades executed on behalf of the client) and as principal (buying securities from the client with the aim of collecting a spread or a mark-up on sales) when helping buy-side clients shift portfolios from one fund manager to another.

One transition manager, dismissed by State Street after the bank admitted in a letter to clients

The wider loss of trust in the banking industry is now affecting the custodian banks and limiting their ability to create shareholder value



that it had evidence of overcharging a client on transitions, took the bank to a London employment tribunal, alleging that mark-ups were approved at the highest level of the bank. The tribunal found that the employee was unfairly dismissed because a fair procedure had not been followed. However, it found no evidence that the mark-ups were sanctioned at the highest levels in the bank. "The dismissal was caused (100%) by the conduct of the claimant," according to the tribunal's judgment.

Although the custodians have fared well in the litigation, the commercial and reputational damage was huge. Institutional investors have greatly reduced the sums they pay for safekeeping, let alone stock loan and foreign exchange, as the custodians effectively pay to retain their business. Investors are openly cynical about the rates paid and charged by custodians in cash as

well as foreign exchange, and make extensive use of monitoring services to keep the banks honest.

Worst of all for the custodians, the consequent political pressure means regulators are taking a close interest in the revenue secrets of the industry.

Savers bear the cost

The involvement of a consumer-focused regulator such as the FCA is a particularly worrying development, because it marks a belated recognition that it is individual savers who ultimately bear the costs of all financial intermediation.

The state of knowledge at the FCA is evident in its starting premise that custodial behaviour in the stock loan, foreign exchange and transition management markets is a desperate remedy for plunging profitability in safekeeping, caused by low rates of interest. "The basic

premise of providing safekeeping and custody of client assets – which is high volume and low margin – is facing strain," it reads. "Consequently, custody banks have become increasingly reliant on revenues from secondary services."

In reality, of course, the intense profitability of those "secondary" services has been for the past 20 years the primary reason for banks to be in the custody business at all. Their profitability in turn depended on data asymmetries and price opacity, and these are precisely the issues the FCA is investigating.

It is concerned that investors are "disadvantaged" or "charged excessively" for secondary services; potential victims of "irregular information" and "unclear fee structures and complex legal and pre/post-transition documentation" in transitions; and are taxed by the "hidden" and "more complex" fees charged by the asset management industry, in which the custodian banks are also heavily invested.

It is at these points that the wider loss of trust in the banking industry is now affecting the custodian banks in particular. Even collateral management, the one business they have identified as other than ex-growth, is over-shadowed. Esma has imposed diversification and concentration limits on collateral across stock loan and swaps and banned re-hypothecation.

The central counterparty clearing houses – the regulatory institution of choice – that devoured the settlement revenues of the custodian banks in the cash markets are active already in swaps and firmly in prospect in securities lending, and will dominate collateral services.

It is increasingly hard to see what custodian banks are for.

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Crisis of trust grows deeper

In the early 1990s, BNY pitched for custody contracts on the basis it was the unconflicted provider. Until the purchase of The Boston Company in 1993, the bank did abstain from managing money but the acquisition of multiple fund managers followed, and the merger with Mellon in 2007 brought more, including Dreyfus and Newton.

Today, BNY Mellon has \$1.4 trillion under management and asset management accounts for nearly a third of total fees. State Street Global Advisors manages \$2.1 trillion, JP Morgan \$1.5 trillion and Northern Trust \$810bn.

While it always seemed imprudent to invest in a second business whose revenues are tied to equity market values, and especially one that entails the additional wager of performance fees, custodians persuaded themselves that asset management was a fee-based business akin to securities processing.

In fact, asset management is a volatile industry rich in operational and reputational risk.

Yet the real reputational crisis in asset management is only now beginning. UK financial regulator the Financial Conduct Authority is

investigating all fees and commissions and expects to find inadequate disclosure, conflicts of interest and "excessive prices being paid out of client funds for services received". Prompted by the Kay Review call on asset managers to disclose all costs, including transaction charges and performance fees, the Investment Management Association has published voluntary guidance on "enhanced disclosure of charges and costs".

This will not restore an industry whose reputation is under an informed and sustained attack for living unconscionably well at the expense of savers. Custodians in particular will relish the irony at the heart of a study of local authority pension funds in the UK currently being circulated to clients by London-based Investor Data Services.

It argues that, at 0.5 to 2 basis points for the majority of funds, the cost of safekeeping is now immaterial. It is the average cost of investment managers (27bps) and their buy-and-sell decisions (37bps in commissions alone) that funds need to reduce. Yes, custodians are invested in yet another ex-growth business.