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The closer, the better

The role of the global custodian in facilitating asset owner's goals

The first decade of the 21st century has seen the world of finance turned upside down. In 2000-2002 we experienced a bear market which brought stocks down to a five year low, only to be followed by an unprecedented rally with the Dow Jones Industrial Average rising to a staggering 14000! In 2008 factors, including loose monetary policy, financial disintermediation and significant increases in securitisation, turned what seemed to be an upward-assured trend into a crash not seen since the 1930s. And yet six months on, the world is moving quickly towards recovery. Perhaps now is the right time to ask what asset owners goals are and what role the global custodian plays in achieving these goals?

The answers to both these questions are simple, asset owners invest for the future; the role of the global custodian is to safeguard their investments.

Rising to the challenge

Martin Kunz, head of global custody product at BNP Paribas Securities Services, explains how global custodians can rise to the challenge of mitigating risks for asset-owner clients in a world of increased volatility and globalisation.

Whether a pension fund, an insurance or reinsurance company or sovereign wealth fund, an asset owner's number one consideration is asset safety – cash safety and safekeeping of assets held on their behalf.

Where is my cash held?

Today, the discussion around cash is very much a traditional banking discussion – how does a bank function? How does the bank hold cash? Why is cash not held separately as client money? Prior to the administration of Lehman Brothers in 2008, people were not asking these basic questions – the assumption was that no major bank would ever go under. Essentially a global custodian is a bank and we are seeing a real return to basics. It is, therefore, not surprising that asset owners are looking in meticulous detail at a global custodian's balance sheet strength, its credit default swap (CDS) spreads, its credit rating, its net asset shareholder equity and its business portfolio diversity.

Digging down

Financial strength is, by no means, the only factor considered in the selection process. Another significant consequence of recent upheavals is the emphasis now placed by clients on the strength of operational procedures and controls and the clarification of asset ownership.

Nothing is infallible

Even the strongest operational procedures and controls cannot guarantee 100 per cent accuracy. Whilst a global custody agreement might provide for recourse to the custodian in the event of a fault, a client must be assured of the global custodian's ability to pay for any liabilities incurred through operational losses. If the custodian loses certificates, or fails to subscribe to corporate events, or fails to convert bonds for example. The amounts involved are potentially huge and clients are asking themselves can their custodian sustain such claims, if there are multiple claims, how many blows can my custodian absorb. So whilst unlike cash, securities do not sit on the global custodian's balance sheet, financial strength is as important for the safety of assets as it is for the safety of cash.

Segregate to isolate

Clients are demanding the clear segregation of their assets so as to be able to identify these through the entire chain - from the global custodian through the sub-custodian to the CSD. It is perceived that identification and ring fencing of client assets ensures that, in the event of a global custodian's insolvency or that of any of its sub-custodians, these assets will not form part of the estate available to the liquidator. The global custodian's due diligence across its proprietary and sub-custodian network is vital to ensuring the safety of assets and making certain that they are clearly identifiable and segregated from the bank's proprietary activity in all of the owner's investment markets. With USD 50 billion still tied up in the disentanglement of Lehman Brothers, it is little wonder that segregation procedures come in a close second behind financial strength in the selection process.

It's all in the model

Segregation of assets by the global custodian contrasts with the «prime broker» model used by hedge funds. Here the prime broker holds the assets on its own balance sheet, as security for finance provided, and is normally able to «rehypothecate» or pledge them in order to raise finance. The problems with this model became apparent with the collapse of Lehman's and the continuing difficulties its hedge fund clients are having in extricating their assets to enable them to continue in business.

Whilst the global custody model differs significantly to prime brokerage model, post Lehman Brothers, segregation nevertheless remains at the forefront of clients' minds. It must be stressed, however, that to date no major global custodian has gone into liquidation. Consequently, although there are legal opinions in place supporting the recoverability of assets in all client markets of investment, there is no legal precedent proving that segregation will ensure the recovery of assets. Irrespective of the name on the sub-custody or CSD account, the account still belongs to the global custodian. This brings us back to the overriding importance of the financial strength of the global custodian, its proprietary and sub-custody network.

"Asset safety comes from robust legal documentation combined with first-class operational processes

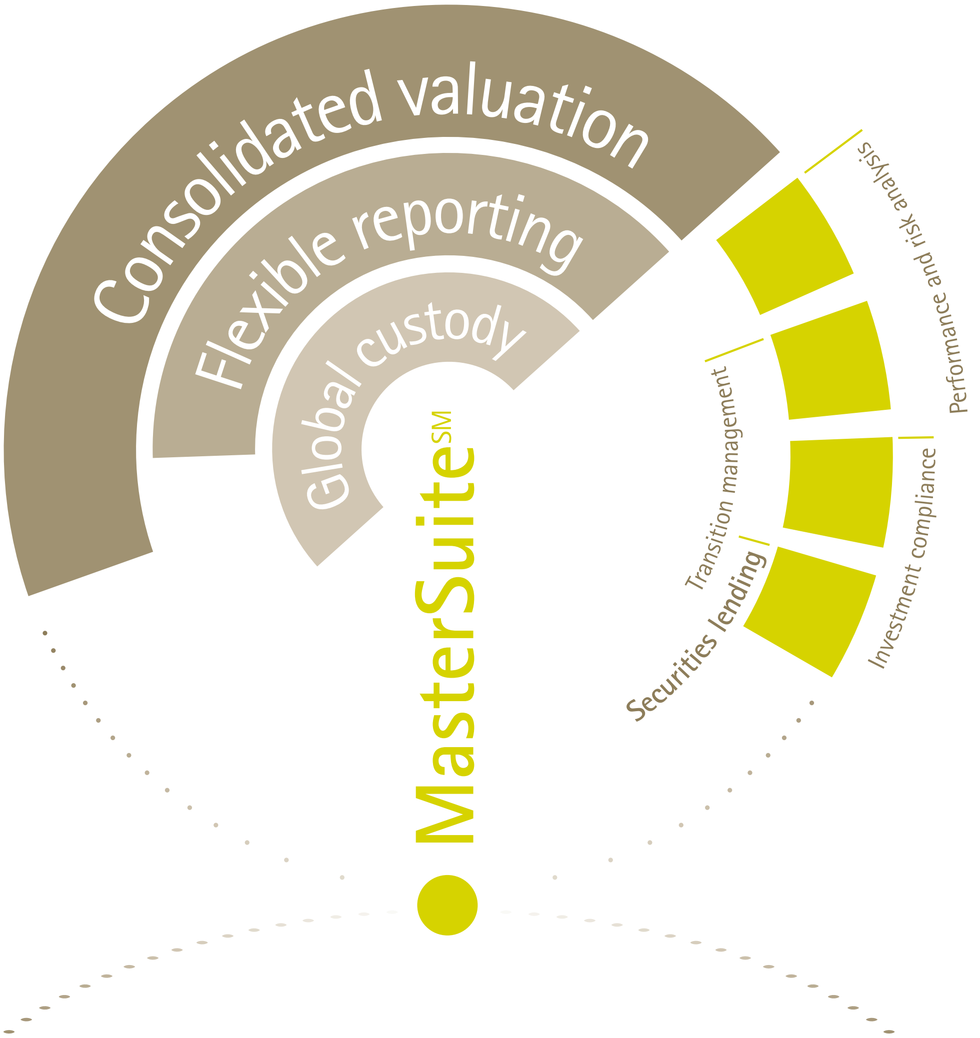
The industry takes the lead

While there may be uncertainty and divided opinion around the legal framework and no precedent to prove that clients will, unequivocally, be able to recover their assets upon the insolvency of a global custodian, market-driven changes are nevertheless coming to bear. To date, global custody models have primarily been based around co-mingled omnibus accounts, where like clients are pooled in one sub-account. Today asset-owner clients are increasingly demanding individual, segregated accounts.

These moves require significant changes to the underlying global custody operating model which today is based on pooled accounts, and thus have a cost and subsequent price implication. That global custodians are ready to make this investment and clients are willing to pay an increased price reflects how the events of 2008 have changed our perceptions regarding the infallibility of financial institutions, perhaps for the better.

The global custodian's role is that of an enabler to global investors. We enable our clients to participate in the global markets through a well controlled and risk-mitigated environment, however it is not our role to underwrite client participation.

Security is very much derived from financial strength, whilst asset safety comes from robust legal documentation combined with first-class operational processes and continued due diligence.



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