Drivers and growth for the sub-custodian

Sub-custody is changing. Senior industry figures from BNP Paribas Securities Services, ING and SEB convened recently to talk pricing, efficiencies, consolidation and relationships

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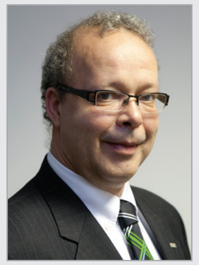
The Panel

Alan Cameron is head of relationship management for global strategic broker-dealers and banks at BNP Paribas Securities Services. He has worked in custody and clearing for more than 25 years, gaining extensive experience in product and relationship management. He holds a Master of Arts in Economic History from the University of Edinburgh and is an associate member of the Institute of Bankers in Scotland.

Lilla Juranyi is global head, investor services, at ING and has been in the business for more than 17 years. ING provides custody and sub-custody services in Bulgaria, the Czech Republic, Hungary, Poland, Romania, Russia, the Slovak Republic and Ukraine.



Ulf Noren is global head of sub-custody at SEB, having worked in both global custody and sub-custody for more than 25 years. SEB's sub-custody venture is now active in 10 markets: Denmark, Estonia, Finland, Germany, Latvia, Lithuania, Norway, Sweden, Russia and Ukraine. He is involved in several industry initiatives and also promotes industry initiatives in such social media as the Benche and Twitter.

Custody Risk: **What efficiencies are you trying to implement?**

Alan Cameron: Firstly, increasing harmonisation has allowed some standardisation of processing and the centralisation of some functions. This has happened more with settlements than with custody. Secondly, we have become more efficient in measuring credit, which has become tighter across the market. So, having a better measurement of credit has become essential to ensure the safety and security of our business, while maximising the services that we provide to our clients. Thirdly, we are moving towards unbundled services and unbundled billing – sometimes we strip out the central securities depository (CSD) pricing – this lets clients see where our costs are and, hence, acts as a spur to efficiency.

Ulf Noren: Also, we have an extreme focus on operational efficiency, especially within the field of settlement. We have also offshored quite a lot of our settlement processing, account administration processes and the majority of mandatory asset servicing processes to an operations centre in Riga, Latvia, fully controlled by SEB and operating as branch of SEB AB.

We also engage with clients on industrialisation projects, going through their complete operational efficiency and identifying where they might cause us trouble and where we might cause them trouble. It is a two-way and completely transparent process in order to become more efficient and to cut costs from both ends. To have an unbundled pricing model, you need an unbundled service model – that is the prerequisite.

Then you need to go into a bilateral discussion with the clients to see whether they can reconcile your unbundled pricing, and whether or not they can allocate it to clients and trading portfolios. We will not see a shift from a bundled model into a full unbundled model – it will be several models being unbundled.

Lilla Juranyi: It is not only the sub-custodians, but the global custodians and the whole banking industry have to go for efficiency increases. The sub-custodian world is more in focus because we are at the end of the chain. We are also under significant pressure to improve the service level and, if we are not doing that in the proper way, ensuring everything is efficiency-driven, it will not automatically happen.

When we are required to provide additional services or tailor the requirements of all our clients, it is very difficult to gain efficiencies on our side. We are centralising services through a Bratislava hub – a country that is well developed, well established and where we have very good and skilled workforces. The majority of that setup is not about client-facing services, it includes setups in the systems, static data, reconciliation, invoicing and corporate action processing.

How far we can centralise processes is another question – can it include settlement and custody? Or, as a sub-custodian, how much local presence should we keep? It needs to be a very good balance because the client-facing side should be left on the local level.

Custody Risk: **What about staffing levels?**

Ulf Noren: We will have client-facing staff at all levels and locations. If it makes sense to have client-facing staff in the processing hub, we have to do it – for example, in settlement. We now have 74 people conducting processes out of Riga at a considerably lower cost than when we did it locally. There are still many people left locally, with complexity and market presence to be the guiding star of that. So, whenever a process is very complicated, when you need to speak

Lilla Juranyi

the language or, for example, when you need to understand local regulatory rules, it is done locally.

The role of the network manager and the relationship manager will develop. We are going to ask a lot more of our relationship managers and you cannot handle everything by sending a full team. From time to time, those guys are going to be completely alone when they face a whole bunch of experts on the client side, so they need to become much more conversant in what is happening. So, you need to grow in complexity, relationship, compliance, credit, etc.

Lilla Juranyi: In discussions with clients, they say it is important to keep settlement at the local level, so we are conflicting with them because the requirement we hear from our clients is different to what we want to do with the efficiency. And why is that a question of whether it can be centralised or not? Settlement – the whole process and the settlement cycle – is shortened so much that, if something happens while going through a hub or through various people in the whole chain, it may take much longer than having the direct contact on the local market, clarifying why there is a settlement failure at their end, and also being in contact with the counterparties.

The speed of communication, whether you are sitting in a local office or in a hub office, is probably not noticeable. This is a requirement of our clients that settlement should be kept at the local market, which is against our efficiency proposals.

Alan Cameron: We are building up a settlement centre in Lisbon – which acts in conjunction with the local markets – as a dual office. So we won't shut down our settlement capabilities in the local markets. This works for the business continuity planning as well, as it means settlement functions can be performed in both locations.

Lilla Juranyi: Yes, especially in smaller countries. We are reviewing staff levels and are still in the process of 'operations to business' in the smaller countries. When you have staff responsible for relationship and business development, and additional separate staff for the operation, how can we put the two teams together? Duty of segregation has to be kept, but the two teams – business and operations – could work more closely, and then it might also result in savings of staff and saving of costs. Everybody has to keep a certain cushion – you need a minimum of two to three people in operations even in a small market where the daily volume is very low.

Custody Risk: Are we going to see more consolidation in the sub-custody community? If so, what is the timescale?
Lilla Juranyi: It will come, but not in one step. Service providers will have to consider whether they are maintaining a real business case or not. And, if not, then how far can they continue the business?

In the summer, we reviewed two subproducts: traditional custody servicing foreign clients and fund administration servicing local asset managers and fund managers. After the project, we decided to close the fund administration business in three countries because, in those three countries – Hungary, Ukraine and Slovakia – there is no real business case in the future. But, in two other countries, we decided to continue the business because we had sufficient market share and we see better growth opportunities. When we announced it, other parties in the fund administration immediately run after the business, and that will bring consolidation.

Alan Cameron: We will see more consolidation as the fixed-cost element of what we all do grows proportionally larger and makes scale essential, and even more so with harmonisation and with banks returning to core services. All of these trends are apparent throughout the banking industry, not just in custody. Furthermore, competition remains fierce, keeping profits and pricing tight. All of this will drive us towards consolidation. Testing for Target2 Securities (T2S) will be the next issue that causes custodians to consider whether or not they want to stay in the game.

Ulf Noren: There is no doubt we will see consolidation. One driver is cost-income numbers that are considerably higher than before, and these need to be explained at governing levels in an organisation. There is a scale need – if you don't have scale, you are probably out. Pair that with investment needs and the investments you need to increase your quality and reach a level at which you are comfortable is quite high. Add on the mandatory investment needs and the numbers become scary. We will see a totally redrawn regulatory environment that will lead to a redrawn map of agent banks.

Custody Risk: Do you have a timescale on the consolidation?
Ulf Noren: The redrawn regulatory map will force people to think, for example, about non-compliance risk. If you are a single market provider, and not extremely strong, you will have trouble. In the Nordics and Baltics, I predict the first major player will leave this business in 2013 or, at least, will scale down to only deal with their strategic partnerships


Alan Cameron

Custody Risk: How are the relationships between sub-custodians and custodians set to evolve?
Alan Cameron: The relationship between sub-custodians and global custodians is somewhat blurred nowadays, but remains strong and important. Global custodians operate in a similarly challenging environment as sub-custodians and seek the help of sub-custodians to drive down costs, simplify processes and better use capital. The difficulties within the markets have pushed sub-custodians and global custodians to work more closely together. And few global custodians want to get into sub-custody – they see it as expensive and know the CSDs cannot provide that service, particularly the asset servicing.

Ulf Noren: The collaboration between sub-custodians and global custodians will become more intense in the next three to five years. Based on the collective regulatory picture, most global custodians will need to illustrate the integrity and protection of client assets by way of registration.

A very limited number of global custodians will see a need to eliminate the third-party risk perceived by using a sub-custodian. Even fewer will open full-blown operations and deal directly with the CSDs. This would be a risky investment and take time to build up competence and knowledge. The best way for those global custodians to achieve this is by way of acquisition, although you need a huge amount of money to buy your sub-custodian.

Lilla Juranyi: The co-operation and dependency of global custodians on the local sub-custodian agency banks are key. In a few markets, we have a maximum of two or three providers and, if consolidation happens and one out of two disappears, then the global custodian has no choice but to appoint the remaining single agent. Some of the global custodians mentioned that they would be scared if it happens, they remain without choice and it would mean a different relationship between the global custodians and local sub-custodians. This should also be a driver for the global custodians. They need to understand they are dependent on local sub-custodians because CSDs cannot provide asset servicing the same way as the local agent banks. It is a question of which service elements can be handed over to a CSD, post-T2S, and it is really the scale business in which the global custodians will need a really knowledgeable local agent bank for asset servicing and market intelligence services. So, the structure will change between global custodians and local custodians. Some global custodians will move into the local custody business to set up the whole vertical chain. It will only happen in the big countries on the basis of selective strategic decision – nobody wants to open up in small markets now.

Alan Cameron: There is even a reluctance to open up in the big Western markets as market conditions are so uncertain.

Lilla Juranyi: I'm not sure if the few banks that are investing heavily will really want to stay after 2016.

Custody Risk: Should the industry lobby harder to bring down charges at CSDs?
Ulf Noren: That would be nice but it won't happen. CSDs will remain our most important infrastructure partner. They are under pressure


Ulf Noren

realising that settlements will be commoditised by T2S. They will face a huge loss of revenue – a scenario that might be the endgame for many CSDs – it is a desperate situation for them. They will face real price competition, many for the first time, and find it very difficult to put a margin on top of the T2S charges.

They will try to find other revenue sources, travelling up the value chain, performing functions of sub-custodians and global custodians, and they will desperately fight the banking part of the positioning game to become a bank. We will see increased tensions between commercial monopoly CSDs and the users of such CSDs. In eight years, the remaining CSDs will perform most of the functions that sub-custodians do today while sub-custodians will develop into something else.

Alan Cameron: CSDs face a very unclear future, it will be very difficult for them. We hope that CSD regulation will ensure the safety of the core functions that they provide. This is key. They face some very difficult decisions regarding what businesses to go into. In the past, the global custodians that have tried to build businesses around local client franchises have found it very hard. There is no reason to believe that CSDs will be able to do that better than the many banks that tried and failed.

The other big issue they face is that they need to develop a service culture. It is not just about having product capabilities.

Lilla Juranyi: The culture of the CSD is different. CSDs and regulators are in strong monopolistic positions – they try to hire knowledgeable people with different cultural backgrounds from the commercial side.

Hiring strong, commercially knowledgeable and client-servicing staff and changing the mind set is a long process, but they understand this will be key to their futures. CSDs do not think they will be competitors to the custodian agent banks in all areas. I separate the settlement, the basic custody the CSDs offer to the local members and international CSDs even today. Servicing the international CSDs already means a competition between the CSDs and the custodian agent banks. But the post-T2S landscape will restructure the markets and we expect a shift of settlement and custody but fewer changes in the asset servicing.

The CSDs will not be able to service the global custodian beyond the settlement and core custody business. The role of CSDs does not necessarily require to understand tailor-made client needs in all of the special taxation issues – the income collection with all the operational requirements – a CSD is not created for this function. A CSD has to take the higher-level support for the market and provide the infrastructure, but leave the local players to do what is better assigned to them.

It is also a key issue that we cannot allow and support CSDs to take over all these services because it will become a monopolistic position, and it will not be a healthy future for investors. Healthy competition is important, though today it is not so healthy, but the competition is ramping up.

Alan Cameron: The really interesting thing is what they will do with the costs they incur getting ready for T2S. We see quite different stances being taken by different CSDs.

Custody Risk: We are talking about CSDs paying for T2S – how are your preparations going?
Lilla Juranyi: We are in the special situation where the services that we are offering are mainly in countries of which only a few will join in the first wave of preparations. So, in central and eastern Europe, T2S is an issue and we are in consultation with CSDs. We are also mentors on the local market to create national user groups to prepare the gap analysis, so we are supporting these markets with our expertise. But we are not directly pressured at this time to make the decision about what ING wants to do with T2S.

Alan Cameron: The most interesting aspect is what T2S is doing to the business models of banks and the clients that they seek to serve, this is unresolved. What we are seeing right now is that clients are willing to consolidate their providers in preparation for T2S, but not many have, as yet, made the decision to change their business model. So they are preparing by consolidating, which will help them go through testing more smoothly. Having fewer providers or not accessing some CSDs directly must make this less onerous, while most are keeping their options open about the different ways of doing asset servicing.

Ulf Noren: In our markets, four countries have said yes to T2S – Estonia, Finland, Lithuania and Denmark. Latvia remains undecided, while Sweden and Norway have said no. We have set up a project to evaluate the four basic models on how we can connect within T2S. Where we spend most energy, for the moment, is in the bilateral talks with clients to make sure that we move together and in the right direction. In order to do that, you need to make sure you set up a model that gives you most of the advantages of T2S in advance of it being introduced. Very few have decided how they are going to do this.

Alan Cameron: Many consider that there is no first-mover advantage.

Lilla Juranyi: In the next few years, new types of requests for proposals (RfPs) will be launched and will focus on segregation of the basic and the asset servicing offering. This will be a new task for local and global custodians. This will be the first wave within the industry and will make some kind of selection on how you can create this special type of RfP as a global custodian – how you can meet the requirements of your clients with this segregation as a local sub-custodian. It will require well-based strategic decisions considering the investment requirements and the baseline costs.

Custody Risk: Which regulations are impacting clients the most at the moment? How are you helping them?

Ulf Noren: This takes 40% of my time, almost all to clients, but also in associations because it is necessary to collaborate across the industry, so trying to prioritise them would be difficult. In the custody world, we have a tendency to focus on the 25 or so 'hot' regulations that directly or indirectly affect us. It is important to see what is driving the banking world, namely Basel III and the fourth Capital Requirements Directive. These will have enormous impacts for the whole industry and they will not always be positive. The capital requirements will drain a lot of capital that could otherwise have been left to the so-called real economy, and so the real economy will suffer. Europe doesn't need enforced suffering now, it needs incentives for growth. But it is there and you can't do much about it.

Alan Cameron: The biggest focus we see from clients is checking that their clients' assets are segregated and secure and, although that may be driven by regulation, it is also a commercial imperative.

Lilla Juranyi: We see that more custodians and global custodians are considering opening up a secondary active relationship, especially around asset safety, and it is again a little contradictory to efficiency and scale. That goes back to the discussions in the late 1990s to early 2000s when it was very popular for global custodians to have a primary agency network. In addition, they tried to set up a shadow agency network, which requires effort by everybody to keep it alive without activity. But, when you need to activate the shadow network, it is a question of whether you can do that in seconds, minutes, one day or one week. So, for network managers, it will also be a task to manage. Basel III is the milestone regulation, it will probably make segregation for the whole banking industry. All banks are preparing for it by divestments, by closing down certain businesses and focusing on the core financial requirements.

Custody Risk: Are asset managers worried about Basel III?

Ulf Noren: They should be worried about Basel III and how their providers can use and allocate their capital. It lies there as an overlay, but they have all the other regulations that will have an impact, particularly on the client side. It will be a volume driver in a negative sense and will put the entire business line into question. For example, in the prime brokerage business models, the European Commission has recently said it doesn't like prime brokerage models – that is worrying.

Alan Cameron: The capital requirements for fixed-income trading could increase hugely. There are quite different estimates being made by the different market participants.

Lilla Juranyi: Even if fund managers are not directly impacted by Basel III, they have to worry whether their banks are compliant, so they are indirectly impacted. Based in Europe, we have to be compliant with all European regulations. But we also must be compliant with all US regulations. What kind of controlling elements do you have to put in place? How much investment do you have to make to be almost 100% sure that you are not missing some element of meeting these requirements? We all have to think about big figures.

Ulf Noren: Although all of this is done with the good intention of improving the reality for consumers, unintended consequences are very possible. One area in which it will not be particularly improved is the cost of doing this kind of activity – it will become more expensive. We needed a return to a more regulated environment, but the extent of regulation has gone too far and will hurt us. One area in which it will be positive is that the corporates will not get the financing they need from traditional credits because the banking industry will be restricted with fulfilling all the regulatory requirements, therefore the corporate bond market will grow quite a lot, so that is a growth area.

Custody Risk: Is it possible to be positive about growth?

Alan Cameron: The industry is not anticipating growth. Speaking to clients, you hear that they are looking at today's diminished volumes as a new reality that they need to operate within, not as something from which they are going to bounce back. There is a generally accepted view that where we are today is where we will be tomorrow. So, if the market remains flat, then any institution enjoying growth will largely achieve this at the expense of their competitors. Although some growth will come from consolidation, some may come from outsourcing.

We are going to go through a period of turmoil and upheaval as T2S kicks in. Some banks will get it right and some banks will get it wrong, and the banks that get it right can hope to grow at the expense of the ones that get it wrong. Similarly, with credit, if you can measure your credit correctly and be confident about it, you will be able to win business from banks that cannot measure it correctly.

There will be some growth around the increasing use of central counterparties (CCPs). Clients will have increasing clearing requirements as they may not be able to connect to the 23 European CCPs directly. However, overall, we don't see the industry growing, but we see some business moving about.

Lilla Juranyi: It will not be growth for the whole industry, it will be a consolidation and shifting powers. We are in the fifth year of the crisis, it is even longer than the Great Depression. The crisis taught us all that we have to think differently and it is not enough just to wait. We have to get back into a more moderate and stable economy, instead of pushing everybody for growth. This is not a very well-accepted concept, but we have to raise this question.

Custody Risk: And will shareholders have to adopt a new mind set?

Lilla Juranyi: Yes, a new way of thinking and also going for new structures.

Ulf Noren: If you look at this isolated business, growth might be the wrong word. But you continue to exist in all areas, but settlement – I really don't see a lot of business drivers to base my future on settlement. You have to become the trusted partner and show that you invest in people to beef up your whole servicing level – your understanding level of what the clients want, what is driving them and where the pressures are so you can help to mitigate them as much as possible.

It means that you also have to grow your risk areas, your compliance areas and your collateral areas – market intelligence and advice will become much more important and it is already important.