mandate research

Core custody service under threat from merger activity

Recent M&A activity among custodians has intensified the argument between the service-oriented niche players and the strong advocates of 'mergers for scale'. But both sides have roles to play, writes **Andrea Coleman**

Demand for global custody is soaring, but custodians are being forced to work harder to retain customer satisfaction.

The continuing trend towards increased cross-border investment has ensured valuable mandate wins for European-based custodians this year. HSBC has secured 61 mandates worth a total of $45.5bn, while ABN Amro Mellon has won 33 custody mandates worth $149.2bn.

However, managers now expect far more from a custodian than core competencies such as the safekeeping of assets.

James Essinger, a consultant to the international securities industry, has observed among fund managers "an increasing sense that more money can be made" through concentrating on identifying and selecting investment opportunities, and outsourcing middle and back-office functions to custodian banks.

The gathering regulatory momentum in the pensions industry has also encouraged fund managers to outsource compliance monitoring and performance updates to specialists at custody houses.

Katherine Johnson of Europlan, a software company specialising in fund monitoring and pensions accounting, comments that growth in the marketplace "has been so big over the past five years that most custodians are still playing catch-up, particularly with regard to technology".

The need to find cost-effective solutions to client demands is at the root of the ongoing mergers and acquisitions activity in the global custody arena.

"The recent mergers of several custodians have affected the market in a number of ways," says ABN Amro Mellon's custody spokeswoman Teresa Byrne, itself created by a succession of mergers.

"The reduction in numbers of custodians both by natural exclusion and acquisition has created a number of larger banks able to operate on a more price competitive basis due to economies of scale."

Ms Byrne says that this in turn has introduced market standardisation as a unified goal, creating a more efficient straight-through processing environment, a wider range of emerging markets and an ability to handle cross-border transactions.

"The pooling of resources has created the level of investment required to drive the technological advances such as web browser technology and internet reporting."

Ms Johnson at Europlan points out that larger players can afford to introduce automated securities lending, performance measurement and performance attribution techniques, allowing them to offer value-added services more cheaply than smaller custodians.

> Experts say the drift to consolidation is some cause for pessimism. There is a view that mergers are bad news, reducing the number of players in the market and feeding the banks' congenital inertia

For Paribas, the decision to merge with BNP was driven by a desire to increase their global presence as well as capitalise on their technological strength.

Patrick Tadj, a network manager at BNP Paribas's Paris-based global custody operation centre, welcomes the opportunity to develop business across the world through the alliance with BNP, which has offices in 83 countries worldwide.

EUROPE'S TOP 6 CUSTODIANS

Name	Assets ($bn)
Deutsche Bank	3963
Mellon Group	2300
[illegible]	[illegible]
BNP Paribas	914.5
[illegible]	[illegible]
Pictet	111.6

Source: Financial Times Mandate Research

Many industry experts, however, regard the drift towards consolidation as cause for pessimism. James Essinger believes that mergers are "bad news", reducing the number of players in the market and feeding the industry's congenital "inertia".

"In the long term, service standards will fall if consolidation and acquisitions continue to reduce the number of market participants," says Simon Balmford of HSBC Global Investor Services.

"The perception is that this will lead to a reduction in competition between the remaining players and consequently to an onset of apathy towards existing clientele."

Ms Johnson of Europlan cites the treatment of one of her pension fund clients.

A custodian appointed by the client had expanded through organic growth and M&A activity with the result that the pension fund felt increasingly neglected.

Ms Johnson stresses the desire of funds to be regarded as "top priority clients" by custody houses, a need that is often catered for better by smaller custodians.

In addition to this personalised touch, Ms Johnson suggests that niche players may well know certain markets better than a larger custodian.

HSBC prides itself on its specialist knowledge of the UK and Far East markets, while BNP Paribas retains a strong network of local offices in its nine MDCC (multi-direct clearing and custody) countries.

These are: Belgium, France, Germany, Greece, Italy, Luxembourg, the Netherlands, Portugal and Spain.

Beth Dowling, a spokeswoman for BNP Paribas, believes that few other banks can match this degree of regional presence, which gives the bank lobbying power with local authorities where taxation and regulations are concerned.

A client satisfaction survey by R&M Consultants earlier this year confirmed the view that while large custodians offer a "wider range of services" they fall behind smaller competitors on levels of client service satisfaction.

Richard Humes, managing director of top-ranked Pictet, believes that it differs from other custodians through better customer service.

Mr Humes talks about custodians with "mediocre service" or relationship managers that often have "neither the time nor experience to provide an excellent service".

However, he rejects the popular belief that sophisticated value-added services are the sole preserve of the larger custodians. "Size gives you certain economies of scale, but no leverage on being innovative."

Mr Humes also suggests that the "personalisation" of services, a traditional strength of smaller custodians, gives them an edge in providing add-on services.

"It is based on letting the client decide what is added-value – not what the custodian says."

Mr Humes employs a shipping analogy: "A supertanker takes a very long time to change direction, whereas a speedboat can manoeuvre rapidly and with great precision."

Mergers: blending systems or bolting on a mish-mash of activities?

Settelmeyer: delivering the basics

Some believe that the industry is rapidly on its way to becoming an "oligopoly", where three or four players eventually dominate the global landscape.

However, in order to achieve any meaningful increase in scale or market share, an acquirer would need to integrate not only highly diverse custody activities but complex accounting, performance, information delivery, custom reporting and database management platforms. Customer satisfaction and retention would become extremely difficult.

A strategy that solves this is the forging of business joint ventures or preferred relationships. If properly executed, the benefits to all parties are impressive. These benefits include: expanded market share, increased revenue potential, enhanced local or regional acceptance, technology transfer, expanded product offerings and, last but not least, improved client satisfaction.

This more tactical growth strategy avoids the "big bang" winner-takes-all strategy of the mergers-for-scale believers.

The remaining list of providers fall into a category of niche participants that either have a more narrowly defined set of products and services, or have a regional or country-specific business strategy. For many smaller players the outlook is uncertain, but others will thrive as their core competencies occupy a niche where the giant global players cannot or will not venture. At the same time, rapid changes in technology will allow the fleet-of-foot niche players the opportunity to keep the scale players up at night.

The big players have blended their US systems and technology and associated array of value-added services with UK and European-configured products and services to offer a one-stop shop. This consists of several key building blocks, which include: global custody (70 plus countries), multi-currency accounting, multicurrency performance measurement, investment manager and total fund universes, trustee and depository services, back-office outsourcing and fund administration and/or transfer agency services.

These services are in turn wrapped with flexible information delivery systems that take advantage of the latest Internet protocols. The transfer agency business is currently going through dynamic change through the use of very sophisticated e-commerce applications in order to satisfy the rapidly developing requirements of the fund supermarket industry.

The rapid change in global security processing (straight-through processing), the constant need to monitor and control risk, combined with the extraordinary pace of technological change is an array of challenging variables.

But the challenges are being accommodated and the positioning of several providers is validating the concept of one-stop shopping.

The real challenge lies in identifying what the ultimate clients want. Time and time again we hear the call to deliver on the basics. Timeliness, accuracy and data quality are the true building blocks of custodial success.

The client today represents a very broad spectrum of end users. Corporate pension schemes, insurance companies, local authorities, investment managers and other banks represent a very large and dynamic universe of clients and associated business potential. This may represent marvellous opportunities for the global custodian's "one-stop shop" strategy; their clients will not tolerate a "one size fits all" service and reporting model.

A formally prepared service level agreement, monthly and/or quarterly review meetings with mutual sign-offs as to accomplishment, religiously prepared key performance indicators and frequent senior manager review meetings are all ingredients to a good relationship programme.

The need for expertise is likely to result in the custodian's move into the provision of consultative services. This is clearly happening in the development of the funds supermarket business, where e-commerce applications are linking providers of fund accounting and transfer agency activities.

Other examples include the streamlining of customised reporting and the associated PC-based information delivery tools. Benchmarking and performance measurement are disciplines being identified as offering a limited number of custodians a major business opportunity.

The rationale is that the fully integrated global custodian will become the provider of choice for these and related services. Their processing power and the ability to deliver more timely and more consistent information will place several of the third-party providers at risk.

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