

# Balancing price and service quality in securities processing

## A Network Management Forum

As the first line of risk management between their organisations and the global markets in which these are active, network managers have traditionally held primary responsibility for maximising protection afforded to client assets, and to optimising standards of securities processing, at competitive levels of pricing.

Given the tight cost environment that has prevailed within the financial services industry during the last 4-5 years, FSR asked leading network managers to reflect on how they have refined their approaches to network management in order to ensure an optimal balance between risk, price and service quality in managing their global requirements for transaction processing and asset servicing.

Respondents were given freedom to highlight any aspect of their network management strategy that they deemed to be pertinent this agenda. However, in order to provide a backbone for their responses, they were asked to reflect upon the following set of issues:

### (i) Strategic adjustments

- In light of the tight costs environment prevailing in the industry, what changes have you made to your network management strategy in order to maintain standards of risk management and processing efficiency?
- How far have these changes enabled you to realise cost savings, without loss of flexibility or operational control?

### (ii) Agent network

- Do you stick to a 'one market, one agent' policy?
- In which circumstances does it make sense for you to employ two or more providers for certain markets and for certain business lines?

### (iii) Direct market access

- In which markets do you self-clear?
- Do you anticipate that direct market access will become an increasingly important option for you in the future?

### (iv) Pricing models

- How will pricing models evolve for transaction processing and asset servicing activities?
- In which areas would you like agent banks to be more flexible in the fee formats that they offer?

### (v) Fiduciary responsibilities

- To what degree have downward pressures on costs impacted on the fiduciary duties that you carry to investor clients?
- Have these cost pressures in any way compromised the level of protection you afford to clients' assets?

Responses were collected by primarily by interview during July 2005. However, one or two network teams preferred to draft their opinions in written format. The views advanced by the network management groups that chose to participate are summarised below.

## The Bank of New York

In the face of the tight costs environment that has prevailed in the industry in recent times, Kevin Smith indicates that the network management team at The Bank of New York has been working hard to reinforce the methods that it employs for measuring standards of service delivery. Central to this process is BNY's report card mechanism.

Through this process, the bank's key operations departments (including settlements, corporate actions, income processing, tax processing, cash management and network management) submit scores for the performance of each of the subcustodian banks employed across its network. In instances where a subcustodian's score falls below a required standard, this issue is taken up with the provider concerned and, where necessary, remedial measures are put in place. The review process is conducted on a six monthly basis. Kevin Smith indicates that BNY has experimented with conducting these scorecard reviews on a quarterly basis and three times per year. However, given the high level of detail involved, the bank has now moved to conducting the review twice yearly.

This process is supported by a comprehensive query-tracking database. "We inherited a Lotus Notes database as part of an acquisition made by the bank in the mid-1990s and we have been enhancing this database ever since," says Mr Smith. "As a result, we were probably one of the first global custodians to maintain a query-tracking system of this sort." This database serves as a repository for all service measurements and report card evaluations, as well as holding details of service level agreements and other relevant information. This allows the bank to provide rolling time-series analysis for a subcustodian's performance for selected periods over a six or seven year timeframe.

BNY has also established a straight-through processing (STP) database, allowing it to monitor fluctuations in its STP rates to and from its subcustodians. "We openly encourage feedback on our settlement instructions to our agent and we monitor performance in this area on a monthly basis," says Kevin Smith. "Again, we seek detailed analysis in this area, particularly when we are paying a repair fee for non-STP trades and STP rates are not at the level we want them to be."

### Pricing structures

With this point in mind, Kevin Smith notes that differential pricing for STP and non-STP trades is now commonplace in the industry and a trend that BNY actively encourages among its subcustodians. "I expect our agents to charge us the best price that they possibly can for an STP trade," he says. "If we look at what is involved, there should be absolutely no human intervention. Therefore, we would expect to cover the agent's overhead, but otherwise there should be virtually no additional charge laid on top of this."

In contrast, for non-STP trades, BNY defends the subcustodian's right to charge a sizeable repair fee. "We want to be as close to 100 per cent STP as possible and to minimise the repair items," explains Mr Smith. "Therefore, it is broadly appropriate that we should be penalised if we deliver non-STP trades. This focuses our minds on keeping our efficiencies as high as possible, and shows that

we are prepared to put our money where our mouth is in terms of keeping repair items to minimum."

Looking ahead, BNY does not envisage a dramatic overhaul of current pricing schedules, based on a transaction fee and an ad valorem fee, in the foreseeable future. "Predicting future business volumes can be difficult," he explains. "With the type of business that we are competing for, some of the business lines are so large that they can radically transform the volumes of business that one is processing. Hence, we need pricing models that are flexible enough to be able to cater for these dynamic shifts in volume. Structures such as fee caps and fee tiers are already in place — and these work well, providing that you have relatively aggressive volumes that enable you to take advantage of these arrangements."

In sum, Kevin Smith is generally comfortable that the pricing arrangements that BNY has in place provide his network team with the flexibility that they need to manage the potential peaks and troughs in business activity described above. "The key is that we do not have a tied timeframe," he notes. "Therefore, if conditions change sharply, then we will go back to the subcustodian and have another discussion about pricing arrangements, even if it is relatively soon after our last set of pricing negotiations. While many subcustodians would be keen to establish a two to three year deal, we are rarely extending beyond 12 months in our current renegotiations."

### Network Restructuring

The Bank of New York has focused attention during the last 2-3 years on consolidating its network through strategic use of multi-market providers. In May 2003, the bank completed a substantial restructuring in its Asia-Pacific markets, consolidating its subcustody provision with HSBC in a number of markets across the region.

In Latin America, BNY has been strategically consolidating its subcustody provision with Citibank and now uses this provider in the majority of the locations in which it is active from Mexico down to Argentina.

In Europe, the diversity of market requirements dictates that BNY continues to employ a range of subcustody partners. The bank maintains a strategic alliance with ING Bank and employs a range of other providers on a best-in-market basis. "Owing to Europe's size and diversity, our European activities are spread across a number of key relationships," says Kevin Smith. "However, I am a firm believer in consolidation whenever this is appropriate. It is crucial to simplify one's network activities wherever possible — whether this be in structuring legal agreements or service level agreements, for example. Network managers' time is at a premium, so we cannot afford to spend large amounts of time renegotiating legal agreements in each individual market. We need to streamline this process and to leverage the processes that we have set in place across the wide range of markets that we are active in globally."

### Market access

One the whole, BNY does tend to employ a 'one market, one agent' policy across its global network. However, there are some notable exceptions where, as a result of the size of its business and its risk profile, it has chosen to employ two or more providers. "In terms of operational efficiency,

we are typically firm believers in using one agent in the majority of markets in which we are active,” says Mr Smith. “If you split your business, this can mean that your workload on the asset servicing side increases significantly. For each corporate action, or each income payment, for example, you will receive two notifications. Furthermore, many agent banks offer tiered pricing schedules and it makes sense to benefit from the highest tier that you can by maximising your business volumes with that agent.”

These points notwithstanding, BNY does currently employ dual agents in six markets. “In Japan, for example, BNY’s overall portfolios are of such a size that it makes sense for us to use two agents,” he says. “Furthermore, given the concerns about the risk profile in the Japanese market in the last few years, it gives an added degree of confidence both to ourselves and our clients to employ two agents in this market.”

BNY has been evaluating the relative benefits and disadvantages of linking directly into selected European markets and has taken three or four European locations as test cases in order to assess whether to revise its method of connecting into these markets in the future. “We already have direct market access for a number of our affiliates and subsidiaries — particularly for Pershing and our other broker-dealer entities that are exchange members in the key European markets,” says Kevin Smith. “On the custody side, we will be watching developments in Europe very closely to assess how the infrastructure develops and whether it will make sense for us to leverage the services that infrastructure providers may be able to offer in the future. However, at the moment, we have not yet reached the point where we wish to pursue this option for our custody activities.” As such, BNY continues to employ a subcustodian in all 89 markets in which it is active, apart from the US and the UK, where it clears and settles its trades through BNY branches in New York and London.

### Fiduciary Standards

Rather than noting any deterioration in the level of protection afforded to clients’ assets in light of the cost pressures prevailing within the industry, Kevin Smith points out that the trend has probably been in the opposite direction — a host of regulatory initiatives have been introduced across a wide range of markets that ultimately impose a higher level of fiduciary responsibility on the custodian. “With this in mind, The Bank of New York has established an extremely thorough regulatory compliance and audit-type environment that is structured at multiple levels,” he explains. “This ranges from monthly review meetings that focus on specific issues relating to BNY’s global custodian business, right through to the bank level, with periodic review meetings headed by the Chairman of the company.”

### Brown Brothers Harriman

Brown Brothers Harriman (BBH) is in many ways a unique animal when compared with its competitors insofar as it is a partnership rather than a corporation, says Andrew Rand, Head of Network Management at BBH. “This has been important in defining a business strategy that is well suited to the custody industry,” explains Mr Rand. “BBH’s size, and the fact that it is privately owned, allow

the bank to adapt quickly to a changing financial services environment. Importantly, the partners have a personal financial stake in the business and a detailed knowledge of the activities of BBH’s respective business areas and how these fit within the overall strategy of the bank.”

### A ‘multi-provider, non-captive’ approach

In its approach to network management, Rand suggests that BBH also differs from some of its peers in the industry. Specifically, the bank has adopted what it labels a ‘multi provider, non-captive strategy’, which gives the network management team freedom to appoint two agents for each market in which it is active. This approach offers a number of benefits,” explains Rand. “Firstly, this provides a convenient mechanism through which we can compare pricing and benchmark standards of service. Secondly, this provides an exit strategy in the rare instances when a subcustodian encounters service difficulties or we need to transfer our business to another provider. Given that we already have a second provider in place in the market concerned, this reduces the pain involved in managing such a transition quite dramatically. We are already familiar with the relationship and we know what to expect with pricing and service levels. As the number of agent banks decreases in many markets, I feel that the advantages of having a Plan B in place in each market will become increasingly obvious.”

In addition to providing a fallback option in instances when BBH encounters service difficulties with any of its subcustodians, the ‘multi-provider non-captive’ approach also provides an avenue through which BBH can foster service enhancements within the market. “We try to ensure that each of our providers maintains standards of service that are broadly comparable,” explains Rand. “This enables us to go back to an agent and say to them, Provider A is delivering this facility but you are not — we would like you to introduce this to your suite of services.” Furthermore, this also allows BBH to highlight areas where a provider’s service standards dip below those on offer from others in the market. “This means of benchmarking service standards is key to ensuring that we are getting optimum standards of service for the prices that we pay in each market in which BBH is active,” says Rand.

But how does BBH go about allocating new business when it maintains two or more providers in each market? “If one subcustodian is particularly strong in a specific area and we take on a new client that has particular service needs in that area, then we will typically allocate our depot to that provider,” explains Rand. “For example, a new client may have a particularly complex tax structure and, if one of our appointed agents is particularly strong in tax servicing, then we would typically use that provider to service that depot.”

More broadly, if BBH does win new business, then it tends to reward the subcustodian that is performing best in the market with that piece of business. In doing so, Mr Rand indicates that his team makes a concerted effort to be as open as possible with each provider in explaining how that piece of business has been allocated and how each can position itself more effectively to bid for future tenders. In instances where service standards across providers tends to be broadly comparable, then BBH will typically put

that line of business out to bid and will reward on the basis of the balance of service quality and price that each subcustodian can offer.

### Market access

Given the risk-averse approach that Brown Brothers Harriman, as a partnership business, has adopted across many of its business lines, it may be unsurprising to hear that BBH has shown limited appetite for self-clearing across its global network. At the time of writing, BBH is only self-clearing in the US and UK.

Andrew Rand intimates that BBH has done extensive modelling to analyse the costs involved in setting up its own operations in a wide range of markets — and it has come to the conclusion, given the downward trend in custody pricing, there is little clear business rationale at the current time for BBH to do so. “My assessment is that you really need to be settling huge volumes to justify putting up bricks and mortar in most markets,” he suggests. “In an industry that is constantly seeking opportunities to move from fixed to variable costs, it is contrary to this whole business philosophy to be increasing one’s fixed expenses by incurring major outlays to establish one’s own operation. Furthermore, if this option does not work out as you expect, it sends out disturbing messages across the industry when you need to reverse the decision and withdraw one’s operations team from a market.”

### Risk management methodology

Cost pressures have hit the industry hard over the last three or four years, but Andrew Rand concludes that these cost dynamics have had little impact on the level of protection afforded to clients’ assets. “It is true that my travel budget is not what it was a few years ago, but it has not compromised fiduciary standards,” he says. “Rather, we have now become much smarter than we used to be in the way that we conduct our market reviews and spend our due diligence dollars.”

To support this, BBH has invested in a range of new initiatives designed to beef up the review process. Specifically, it put a new query tracking system in place in 2002. Over the last three years, it has also introduced new reporting procedures for each of its agents, banks and depositories, including six-monthly agent report cards across its global network. Alongside this, the network and operations team completes ‘wellness checks’ for each of its subcustodians on a weekly basis, providing a ‘quick check’ monitoring process that will highlight significant upturn or downturn in STP rates, settlement rates, repair rates and other operational indicators, as well as the factors that may be contributing to these perturbations.

SEC Rule 17(f)5 has set in place a framework through which US organisations must maintain periodic risk reviews on the non-US custodians that they employ. Andrew Rand indicates that BBH has used this framework as a starting point, and has then enhanced it to ensure that it has robust and sophisticated risk monitoring structures and methodology in place. “We require our local agents to provide an annual legal opinion regarding the rights to recovery of cash and securities in the event of bankruptcy and we demand a third-party audit letter to validate their internal risk environment,” says Rand. “In addition, BBH

has sophisticated procedures to monitor liquidity risk, transaction risk, credit risk, and legal and regulatory risk, in each market in which it is active.

### Alternative pricing models

Looking ahead, the feeling at BBH is that the financial services industry will need to become progressively smarter about the ways that it negotiates both service and fees. The need to ensure that there is active competition between service providers, and a strong sense of mutual cooperation in order to drive standards, is vital to the well-being of all parties involved. “Without active competition between providers, there is little in the market to drive improvements in services, pricing and flexibility,” comments Mr Rand. “Hence, it is in our interests, and it is our responsibility, to ensure that there continues to be a choice of service provider within each market.”

In practice, this will require that network managers negotiate fee reductions with their agents on an incremental basis in order to give the latter time to adjust and to innovate. Reduced revenue flows will require that agents squeeze greater productivity out of their staff and systems and this cannot be sustained if network managers are taking a hatchet to the fee schedules in each round of fee negotiations.

With this in mind, Rand suggests that there is still a place for current pricing models based on transaction fee and ad valorem fee components. “Given the levels of automation in the industry today, it does not cost markedly more to process a US\$1 million trade than it does to process a US\$10,000 trade, and this is reflected in the transaction fee,” he explains. “However, on the asset servicing side, the risk attached to a complex corporate action will be closely linked to the valuation of the asset concerned. Thus, an ad valorem fee does still hold merit in reflecting this risk premium.”

### Concluding comments

Some might argue that a network manager’s job is easier today than it was five years ago due to the dearth of subcustody choices in many markets. Years ago, network managers had to review half a dozen banks in each market. Today, most markets in Europe have half that number of choices. With fewer agent banks, subcustodian selection is made easier. Or is it? After years of attrition, network managers are now faced with the issue of monopolies or duopolies in the markets. Arguably, negotiating power has diminished, despite the fact that the depots of those custodians remaining in the industry have grown to astronomical proportions. To remain viable, global custodians must embrace change and be able to thrive on complexity. Network management groups are being asked to reduce expenses, reduce risk, maintain choice in the network, and maintain a high standard of care. All of this must be achieved while continually reinventing oneself. Easier?

“As the US custodian bank of choice for European and Japanese banks, BBH is well-positioned to work with these banks in new ways,” says Rand. Several European custodian banks have looked to BBH for the white-labelling of network management services, whereby BBH acts as the master custodian. BBH’s market practice



guides, news information products, analysis, relationship management, due diligence, etc., are outsourced to these European financial institutions. “In order to do this, BBH has had to demonstrate flexibility in its approach to Network Management,” he concludes. “This flexibility has been a key component in our ability to attract new business.”

## Dexia Fund Services

Dexia Fund Services has been active during the past three years in revisiting its network arrangements for the entire Dexia group, with the objective both of reducing the costs of its agent bank network and better exploiting the service range offered. “We have not only been recognised as a strategic partner by our agent banks, but the impacts for our clients have also been extremely positive,” declares François Drazdik, Vice President and Head of Securities Services at Dexia Fund Services. “The result today is that we have dramatically reduced our costs, while enjoying more attention and, in many cases, a real improvement in the service level that we are able to offer to our clients,” adds Sabine Inghelbrecht, Head of the Network Management at Dexia Fund Services.

### Streamlining operating procedures and reducing risk levels

After in-depth analysis, Dexia has opted to migrate from a segregated account structure (opened at the sub-funds level) to an omnibus structure (pooling portfolios with the same legal and tax status) for its clients in many markets. Streamlining the account structure had a positive impact for all partners in the value chain. François Drazdik reports that by doing so, his team has been able to reduce the number of accounts from 650 to 35 in some countries. This has allowed it to deliver additional value to its clients by allocating its resources more efficiently across its work chain. He notes that this move has been highly appreciated by the agents in its network and has offered new possibilities for MIS reporting.

Having become the negotiator for the entire Dexia group, Sabine Inghelbrecht indicates that the network management team has, through a ‘win-win’ approach with its agent banks, been able to reduce costs by approximately 35 per cent on a yearly basis at the group level and to pass on a major share of these cost savings to its clients. “In fact, decreasing our subcustodians’ workload by simplifying the account structures is just one of the paths we have followed,” she explains. “Increasing the volumes has clearly been another essential element of the discussions. For some countries, we decided to select a new subcustodian. If the fee levels were an important element, the level of service we could expect has always motivated the final decisions.”

### Market access

Dexia’s policy has historically been to appoint the best local agent bank in each market in which it is active in order to mitigate risk and to facilitate clear monitoring of assets. As a consequence, it is now running a network of 81 markets, with a local agent bank in each market. Dexia Fund Services does work with some regional players in Asia and Eastern Europe, but always maintains

a direct contact with the local custodian. “Choosing our subcustodians through an in-depth selection process, we obviously always primarily recommend our agent banks to our clients for their top-edge service level and try to stick to the ‘one market, one agent model’ for efficiency reasons,” says François Drazdik. However, in some cases flexibility is essential in order to respond to specific needs of a particular client. “These ‘one market, multiple agent’ situations lead to additional workload and specific risk management measures, but represent just a small percentage of our operations,” he adds. “I consider these exceptions to be the natural consequence of our flexibility.”

In some markets, Dexia Fund Services is evaluating the benefits of consolidating its agent banks by appointing a regional provider. This may be a comparatively simple task in Asia, where it notes that regional providers are highly committed to the custody business in the region. However, this approach may be more complex to apply in the Nordic countries, where considerable restructuring is currently going on at the infrastructure and the agent bank level and it may be premature to take this step. The same applies for Southern and Latin America, where Dexia has noted that the range of agent banks appears currently to be proliferating, rather than falling in this region.

On balance, a key differentiating factor for Dexia Funds Services in the current service environment is the flexibility provided by its agent banks. “A prerequisite for a good agent is the ability to demonstrate a true understanding of our needs,” says Sabine Inghelbrecht. “Given that our own clients are quite demanding, and increasingly looking for tailor-made services, we need to be able to ensure the same level of flexibility from our agent banks. Currently, most of our subcustodians do offer a wide range of value-added services and this helps us to ensure that we get the service support that we need to meet our own clients’ needs effectively.”

Dexia Fund Services does not consider direct market access to be an integral part of its core business. “A way of having direct market access is via the other Dexia entities that are well-known local market players with custodian capacities,” says Ms Inghelbrecht. “We are, for instance, working with Bancoval in Spain and are looking into closer collaboration with Dexia Bank Brussels for the Belgian market. We also have plans to expand that activity in France and Italy on an opportunistic basis.” The Dexia team is not convinced that it is the role of CSDs to extend their range of services to asset servicing areas and other areas out of their core services. It predicts that this may end up in CSDs competing with their own clients, and may confront them with service levels and costs that are tangibly different from what they know best.

### Pricing models

In concluding, François Drazdik and Sabine Inghelbrecht indicate that their objective is always to offer to clients the highest level of control on their costs. “This is obviously much easier when we get transparent fees schedules with single pricing in terms of transactions and safekeeping from our subcustodians,” they suggest. “This will avoid additional costs for communication, corporate actions and other items. “In an ideal world, we would negotiate flat fees with all our agent banks, allowing us to offer extremely

simple pricing models to our clients. Our aim is to offer this scheme as far as possible. However, for some markets (in emerging markets, for example), agent banks are in a position to impose a sliding scale model.”

## Fortis Bank

Fortis Bank's Network Management Group has been approached by many of its clients during the last couple of years in order to negotiate for fee reductions. This has created considerable pressure on network managers, who have been focusing increasingly on lowering the fees that they pay to agents within their network. Logically, Fortis has tended to demand the same level of service, or sometimes increased service levels, at a lower price. “However, most of our agents are professional, who can cope with such demands,” it reports.

This trend has forced Fortis Bank to explore alternative methods of managing its network in order to secure improved service quality at cost. In this context, the possibility of disintermediation has become increasingly real. Fortis initiated a process some time ago, whereby it began to evaluate the potential benefits offered by establishing a direct connection into certain markets, particularly those supporting significant levels of business activity from clients. On the basis of this research, the bank has established a direct link into the infrastructure in a number of markets, or it has opted to establish its own branch. This decision is typically shaped by transaction levels and size of portfolio, as well as the market's complexity and whether or not Fortis has a branch in that market.

Agent fees are consistently being shaped by market infrastructure pricing models and this will increasingly be the case going forward. In response to this trend, service providers will be under pressure to adapt their own operational costs, their risk costs, and their required profit margin, to infrastructure prices.

## One market, one agent

Fortis Bank has always tried to stick to the principle of only appointing one provider per market. There are a few exceptions, predominantly to service specific types of instruments or product, where the bank has appointed more than one agent in a market.

## Fiduciary standards

Fortis Bank concludes that downward pressures on costs has in no way compromised the level of protection afforded to clients' assets. The network team will in all circumstances opt to pay a higher fee, rather than accept a higher level of risk.

In general, the Network Management team concludes that competition between agents in a market is important in order to drive forward standards of service and to enhance standards of risk management. As such, the presence of at least two more or less equal competitors in a market is something that typically is to be welcomed. However, if one of the agents is forced to exit the market, this will not necessarily result in a reduction in service quality extended to underlying clients. “There is always the option of appointing an alternative provider and also the possibility that service deficiencies can be resolved internally,” it notes. “Thus, clients should not notice any

discernible decline in service.”

In order to reinforce its internal control environment, Fortis Bank has recently received an ISO9001 certificate and expects to receive a SAS70 certificate within the next couple of weeks. “These two certificates do help us, together with the other procedures that we have in place, to constantly keep operational procedures up-to-date and to make enhancements when appropriate,” it concludes.

## HSBC's Institutional Fund Services, Europe

Irrespective of cost, delivering a quality service is a given and there can be no compromise, notes Mick Underwood, Deputy Head of Network Management, Institutional Fund Services (IFS), Europe (a part of HSBC Securities Services). His team has responded to cost pressures through measures to improve internal efficiency, particularly through efforts to boost Straight-through Processing (STP) rates. “This is something that we actively pursued with our agent banks last year, especially in the corporate actions area,” says Underwood. “We will be progressing this further during the remainder of 2005 in order to improve the quality of corporate action SWIFT messaging across our agent bank network. More broadly, we will also be working with our clients to improve the quality of their incoming SWIFT instructions.”

## Network Restructuring

Having been busy during late 2004 and early 2005 in managing the transition of the Bank of Bermuda's business, which was brought under HSBC's umbrella as a result of the acquisition announced in October 2003, the network team has also been active in integrating the network function for HSBC's Investment Banking arm into its custody network. Where possible, it has made efforts to consolidate all of its business with a single provider in each market in which it is active. This has enabled it to reinforce its purchasing power and to reduce costs through improving economies of scale, as well as to introduce standardised service and pricing for different business lines across the HSBC Group. Furthermore, by consolidating business through a single subcustody provider, this has ensured that the network team has fewer relationships to manage, thereby reducing the due diligence burden and the quantity of documentation generated by custody agreements, service level agreements, and so on.

In parallel with the above, the network team has further work to do in consolidating the network function for other business lines within the HSBC Group, including Private Banking, CCF (HSBC's French retail, corporate banking, asset management and insurance arm), and Alternative Fund Services. “Where possible, we will align these with our preferred network, so there is much opportunity for extracting additional value,” says Mr Underwood. “In addition, we have recently been given the mandate to take responsibility for the HSBC Group's cash network as well as the custody, and to this end we will be expanding the team even further. The effect will be that each network manager will have more products to deal with, but across fewer countries.”



### Market Access

We have noted that HSBC's preference is for one agent in each market for the reasons indicated above. Mick Underwood indicates that this has been relatively easy to achieve in the past, since its clients' main focus has been on equities and debt instruments. However, now that the network team has assumed responsibility for HSBC's Investment Bank arm and has taken on board new business acquired through the Bank of Bermuda purchase, the team now has exposure to a significantly wider client base that deals with derivatives, hedge funds and commodities. "Although we aim to consolidate as much of the HSBC Group's business as possible through our appointed provider in each market, we will need to look closely at how the service delivery requirements for these new products differ from those of our normal custody business, and to ensure that they are integrated effectively within our service level agreements and due diligence review process," he explains. This may necessitate having to choose a provider by product line, as HSBC does in the US market, where it employs one agent for equities clearing, another agent for fixed income clearing and another for custody. "This may not be as cost effective as using one provider for everything, but in some instances it is not possible to find a single provider that can service all products to the standard that we require," adds Underwood. "Given that we are not prepared to compromise on service quality, this is a strategy we are prepared to adopt irrespective of cost."

In exploring the relative benefits of self-clearing, Mick Underwood notes that building and maintaining self-clearing capabilities requires banks and broker-dealers to make a substantial investment and resource commitment in both the short- and long-term. "For us, the determining factor regarding whether we take the agent or self-clearing route is purely down to cost and volume," he says. "Where we have the trading volume to benefit from the necessary economies of scale, then we will look to the self-clearing option."

Consolidation of market infrastructure at the exchange and clearing house level is destined to hold important implications for HSBC's Investment Banking arm and they are already exploring the possibilities of adopting a pan-European solution for its clearing business. HSBC's Investment Bank has recently adopted a regional solution for the Nordic markets to take advantage of the ongoing consolidation that has been taking place at the infrastructure level in this group of markets. Later in 2005, HSBC's Investment Bank will be evaluating the benefits of adopting a regional solution in the Central and Eastern Europe (CEE) region.

For the custody business, the key development during the next three years is likely to be at the depository and ICSD level, with the launch of Euroclear's Single Settlement Engine (SSE) planned for 2006 and the Single Application Platform (SAP) destined to go live in 2008. "We have been actively involved in consultations with Euroclear on their plans during the past two years and we have a representative on Euroclear's Common Communication Interface Working Group," says Mr Underwood. "Also, John Gubert, Global Head of HSBC Securities Services, is a main board director of Euroclear and is actively involved in the approval of Euroclear's SSE and SAP strategy."

In parallel with the above, HSBC Securities Services has set up a European Strategy team that will monitor and review developments in Europe in order to ensure that the HSBC Group is ready to respond to any imminent changes. "Our strategy will include selling global custody to European clients using our UK processing capability as a hub and contact point into the newly-consolidated Euroclear CSD and other depositories," explains Underwood.

### Pricing Models

In general, pricing tends to be cyclical and Mick Underwood expects network managers and subcustodians to continue to refine models based on transaction fee and basis point charges, and on per-line charges. However, the latter tend to be attractive only in falling markets where the valuation of assets is contracting as the market moves downwards. HSBC Securities Services is now seeing more and more agents introducing monthly minimum account or relationship fees and a greater focus on claiming back out of pocket expenses. "In terms of flat fee or capped charging structures, I think that this will be driven by the clients or consultants and if we, as a global custodian, are pushed down this route, then we will look to marry up with the agent fee structure," he says.

In terms of subcustodian service, HSBC Securities Services is now looking to its agents to provide more value-added products, such as contractual policies (i.e. settlement, income and tax reclaims), improved use of float monies, enhanced tax services and for excellence in client and relationship management support.

Significantly, IFS Europe is now seeing its own custody clients requiring it to take on more of the market risk. However, for custodians this means increased costs due to the requirement to set aside capital under Basle II. "Although this trend is being driven predominantly by consultants through the RFP process, the clients are rarely keen to pay for this extra cost of capital," notes Mr Underwood. The securities business is a risk business and it is appropriate that those that choose to invest in these markets understand and accept these risks. If custodians are to become insurers against risk then they should be able to charge the associated premiums.

### Fiduciary Responsibilities

Mick Underwood is firm in the belief that HSBC will not compromise on quality or protection, regardless of the cost dynamics at work in the market. Indeed, despite tight cost pressures that have prevailed within the industry in recent years, the network team has actually increased the level of protection afforded to client assets by extending the level of detail requested as part of its annual legal opinion exercise in order to ensure optimum protection of assets held in each market.

The network team remains highly focused on risk management and has a dedicated Operational Risk and Control Team within the custody area. HSBC Securities Services has also subscribed to an external supplier's Capital Market Risk Reviews and Depository Risk Evaluation Services, covering almost 100 markets. This risk information is subsequently extended to its clients.

### Concluding Points

“In Network Management, it is our job to get the best service at the lowest cost,” says Mick Underwood. “However, there has to be a bottom line and there comes a point where it is not cost effective for the provider to continue to invest in new resources and products. In these circumstances, you either get deterioration in service levels or the provider goes out of business.”

In some markets, we have probably got quite close to this bottom line, concludes Mr Underwood. With other providers — for example, the ICSDs — he suggests that we are not yet close to this threshold. “In this case, we feel that we continue to pay for the ICSDs’ pan-European ambitions,” he says. “On balance, I believe that we all have a responsibility to ensure that there are enough local subcustodians in the market to generate healthy competition. This is what drives up quality of service. There are clear dangers to service standards implied by driving subcustodians out of business by squeezing down fees too far.”

### JPMorgan

JPMorgan’s Network Management group carries responsibility for managing the network requirements of JPMorgan Investment Bank and JPMorgan Treasury and Securities Services (which brings together JPMorgan Worldwide Securities Services and JPMorgan Treasury Services into one business unit). The Network Management group has been involved in a substantial re-engineering of its network activities over the last five years in order to enhance the standards of processing efficiency and risk management that it receives across its agent network.

Geoff Harvey, a Vice President in JPMorgan’s London-based Network Management group with responsibility for JPMorgan’s Investment Bank network activities in EMEA, reports that the Network Management team has focused on maintaining a tight rein on costs in recent years in order to protect its margins. “During this period we have seen sustained volume growth” says Harvey. “However, like many of our peers in the industry, we have been subject to pressure on revenues throughout this time. Consequently, it has been necessary to monitor closely what we pay to agent banks in settlement and custody fees, and to maintain tight control over how much is paid in infrastructure fees — for example, to exchanges and clearing houses. However, infrastructure fees tend to be fixed at the market entity level and we have typically lobbied for changes in this area through industry bodies, such as the London Investment Banking Association.”

The fundamental objective of the re-engineering work conducted by JPMorgan’s Network Management group has been to strive consistently to achieve an optimum balance between service levels and costs. “In selecting our agents, we aim to pick the ‘best in class’ in each market in which we are active,” notes Harvey. “In doing so, we expect an agent to provide high service quality, processed through an efficient operating model. It is imperative that we strike an effective balance in the ‘costs versus service standards’ equation.”

### Restructuring strategy

The restructuring efforts that the JPMorgan Network

Management group has undertaken to secure this goal have been founded on four strategy pillars.

Firstly, fair compensation for the agent. If a task is relatively straightforward, and involves relatively modest levels of risk, the fee paid to the agent will be relatively low. By comparison, if a task is particularly complex, and it involves higher levels of risk, then the fee paid will be higher to take this into account.

Secondly, building and maintaining an effective partnership with agents is key to ensuring that the Network Management team can work effectively with the agents to develop solutions that are acceptable, workable, and mutually beneficial to both parties. It is also important in providing an effective feedback channel, through which the JPMorgan Network Management and Operations teams can solicit recommendations regarding how they can manage their activities more efficiently, and in a way that improves synergies with the operational approaches employed by its agents. “The best agents”, Harvey observes, “differentiate themselves from the rest not only through superior service, expertise and responsiveness, but increasingly also through superior pro-activeness, coming to us with ideas for improvements”.

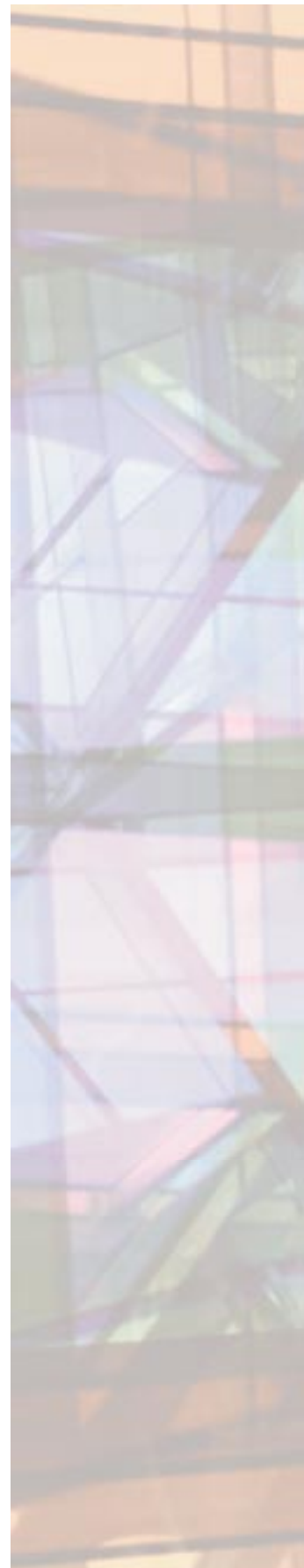
Thirdly, in line with capital market changes that are occurring within the European region, the Network Management team is constantly reassessing the potential benefits that a shift to self-clearing of securities might realise in one, or a number of markets. Currently, JPMorgan employs an agent bank to service its business in the vast majority of markets in which it is active. However, Mr Harvey points out that this is open for periodical re-evaluation and direct interface to settlement, clearing systems and securities are not discounted, subject to the ability to secure an optimal balance between service quality and costs.

Fourthly, JPMorgan is constantly looking for avenues through which it can leverage scale benefits in order to realise lower costs and improved service quality. Typically, this means that, where appropriate, JPMorgan will look to service its different business lines through a single agent in a particular market, in order to take advantage of economies of scale and to avoid diluting its expenditure across multiple agents. This arrangement has the added benefit of being more straightforward for clients.

### Restructuring process

The task of converting these principles into practice has involved moving away from the traditional blended pricing structures and putting differentiated fee schedules in place that in some cases ‘best fit’ the market. “You can only truly maximise these types of structures by really understanding how the market operates, a trait advocated by the JPMorgan Network Management team based on the importance of regular ‘in-country’ visits and meetings with market participants to enrich such understandings, whether identifying true market costs or exploring further opportunities for operating efficiencies,” Harvey states.

Subsequently, as the Investment Bank of JPMorgan became a remote member of more exchanges, and shifted a progressively larger share of its trading activity from OTC to on-exchange, the Network Management group negotiated with its settlement agents to pay a substantially



lower fee for exchange trades than for OTC. “In short, the difficulty and risk borne by the agent in settling an exchange trade is markedly lower than for OTC,” says Harvey. “The challenge from our side has been to establish a more rigorous understanding of the transaction flows into our agent banks, in order to identify where the risk and difficulty lies in processing these transactions, and to negotiate our prices accordingly.”

JPMorgan then focused on developing its partnerships with its agents, particularly those at the high-volume end of its roster. While references to ‘partnership’ can sometimes be overused in the financial services industry, the need for collaboration and mutuality of this form remains invaluable in order to secure developments in efficiency, and movements on price, that are sustainable for both parties. “To give one example, we have needed to work closely with agents to identify the impact that introduction of netting arrangements within a market would have on our respective business models,” says Harvey. “If the agent and market can support instruction of trades on a ‘net’ basis, we have the possibility of condensing several thousand trades to a potential ‘net’ figure of 30 or 40 ISINs, with just a single transfer of cash and securities taking place against each one.” For this reason, the introduction of netting can dramatically reduce the transaction-based income accruing to the agent. “To ensure that the agent continues to receive fair compensation for the work that they do on our behalf, we needed to discuss these developments carefully with the agent and to renegotiate our pricing models accordingly,” he says.

Most recently, the Network Management group has also been evaluating the respective benefits and costs of appointing regional providers in certain groups of markets. JPMorgan has adopted a similar approach to that mapped out above: it will consider regionalisation of its network strategy on a case-by-case basis, weighing up the respective implications on cost and service quality.

### **Pre-requisites for balancing cost and service quality**

To optimise the balance of cost versus service quality, JPMorgan ensures that fee schedules must be fully transparent and unambiguous. Whenever possible, pricing schedules should be ‘unbundled’, dictating that if a cost is associated with the service provided by an agent, then this should be articulated clearly in the fee schedule. “The crucial factor is that, as a Network Management group, we know exactly what we are paying for,” says Harvey. “We do not mind a more comprehensive fee schedule in some circumstances if this improves our understanding of what we are paying for.”

The second pre-requisite to effective cost oversight is regular reviews of current and, where known, future business trend/models versus current fee models.

### **Realising benefits**

Through the re-engineering strategy outlined above, the JPMorgan Network Management team has effectively managed agent expense in the five or six years that this process describes.

Importantly, Geoff Harvey makes the point that these

savings have generally been achieved through the process of negotiation and partnership with existing agents in its network, rather than by constantly replacing one agent by another. “It would be very unusual to exit an agent to solely realise the cost savings that I have outlined,” he says. “That said, we are not adverse to agent migrations should the service/cost requirement not be met”.

In closing, the pursuit of the optimal combination of service and cost continues to evolve. For agents to remain competitive, they require scale and efficient processes. Given the competition, some may fall by the wayside, while others may look to take advantage of multiple market offerings and to re-examine their location strategies.

## **KAS BANK**

KAS BANK is well placed to comment on the service and pricing dynamics addressed in this survey article, representing both a provider of third-party custody and clearing services across a range of European markets, and a global custodian and provider of investment administration services to a variety of European clients.

Ellen van Krimpen, Head of Network Management Global Custody at KAS BANK, notes that the bank offers services to three wholesale client segments:

- Institutional clients, to whom KAS BANK offers global custody and a range of fund and investment administration services.
- Banks and brokers, to whom KAS BANK offers a one window clearing, settlement and custody product, principally for European business.
- US and European banks, to whom KAS BANK offers subcustody services, mainly in the Netherlands and UK, but also selectively in other European countries.

In each category, KAS BANK offers an individualised and tailored service to clients that can be bought either as a bundled package, or on a product-by-product basis.

### **Growth trends**

A key driver for business growth for KAS BANK during the last 2-3 years has been an upturn in the European trading activities of the European (especially the UK) brokerage community, with brokers gaining remote access to more and more exchanges and the development of smart order-routing technology to support their trading activities. “In response to this trend, we have established direct links to the leading European infrastructures: the Netherlands, France, Belgium, the UK and Ireland, but also to Germany and Switzerland,” explains Ellen van Krimpen. “With the formation of Euronext, for example, we have fulfilled the requirements of brokerage clients that are now able to trade across four different exchanges, including Portugal. We have developed an integrated clearing and settlement product to support this activity, establishing direct links to the CSDs and Central Banks in France and Belgium to enable us to service the Euronext market both for cash and derivatives.”

Ms van Krimpen points out that this policy has enabled KAS BANK to be price competitive across each of the Euronext markets. Based on cost evaluation, risk management and operational efficiencies, KAS BANK has also established direct links to the German and Swiss infrastructure. As a result, the bank is able to offer its clients

(namely remote members of Euronext, LSE, Xetra, SWX and virt-x) a broad selection of products.

### Market access

In providing global custody to its institutional client base, KAS BANK complements the direct links that it has established into a number of European markets with an extensive agent bank network to service markets where it does not have a direct presence, or where regulatory and service requirements dictate that it uses an agent alongside its own service offering.

In the Euronext area, KAS BANK is a General Clearing Member of LCH.Clearnet (or its component parts prior to the merger) and a direct member of the respective CSDs in these markets.

In Germany and the UK, the picture is relatively simple, given that KAS BANK maintains its own direct link to the clearing house and the CSD in both markets. In Portugal, however, KAS BANK supports remote membership for brokerage clients on the exchange, but continues to employ an agent to settle its trades (for clearing, KAS BANK is a member of LCH.Clearnet). “This is a question of complexity of the market in relation to the exposure to the market,” notes Ellen van Krimpen. “Portugal is still a growing market and, on the grounds of cost efficiency and complexity of the market, we decided to continue to employ an agent in this market. Through this combination of exchange membership and agent bank support for the post-execution element, we are able to offer an integrated Euronext product to our clients, and to receive the market information and reporting that we require via our subcustodian in the market.”

To complete the range of clearing products, KAS BANK is also able to offer a clearing and settlement functionality for the Italian and Nordic markets via its agent banks in these markets, namely Banca Intesa in Italy and Svenska Handelsbanken in the Nordics. KAS BANK has established a close cooperation with these agents, which goes beyond a normal subcustody relationship.

### One market, one agent policy

In providing global custody for Dutch institutional clients, KAS BANK has opted to appoint different regional providers to service its clients in a number of regions, including the Asia-Pacific, Central and Eastern European, and South American markets. “This strategy allows us to maintain a broad level of market coverage for our custody clients at a reasonable cost,” says Ellen van Krimpen. “In the CEE, for example, we maintain direct accounts with Bank Austria Creditanstalt’s local agents in the more prominent locations (eg Poland, Hungary, Czech Republic) and we can link via BA/CA’s Vienna hub into the lower volume markets. This allows us flexibility in what we can offer to clients, enabling us to offer many more markets than it would be viable for us to be active in directly, and allowing us to do so at an acceptable fee.”

In order to drive innovation and standards of service within this environment, the financial health of agent banks that KAS BANK employs, and the existence of tangible competition between service providers, remains of crucial concern. “In comparatively low volumes markets, it makes sense for KAS BANK to link into the market

via the hub service offered by our regional provider,” says Ms van Krimpen. “The business activity that we have in these markets is simply not large enough to warrant the detailed research needed to select the cheapest and most efficient provider on a market-by-market basis. As such, it is important to us that our subcustody provider remains in business, that it is generating sufficient revenue to maintain high service standards, and that there is sufficient competition in the region to drive innovation and product development.”

Indeed, there have been several instances in the last year or two where a regional provider has made a decision to withdraw from a market, and this has sometimes created substantial difficulties for their clients — leaving the latter with a significant problem in finding a suitable alternative provider and, in some instances, forcing the global custodian to advise investor clients that they should sell their assets held in that location.

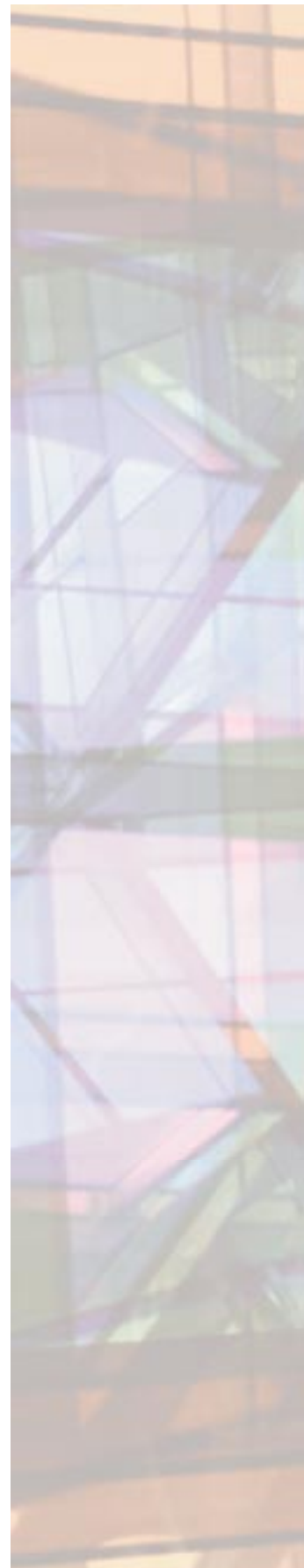
### Price dynamics

In turning her attention to pricing structures, Ellen van Krimpen identifies a need for the industry to move to a more standardised methodology for pricing the services offered by subcustodians. “As a buyer of subcustody, I should be able to compare fee proposals of several subcustodians. The consequence is that, for agent banks, it is difficult to distinguish themselves, because these proposals do not include distinguishing parts of the service array,” she notes.

Ms van Krimpen would welcome pricing structures that will allow a provider to price their ‘value-added’ services more effectively — thereby providing better reward for the areas of service excellence that allow a provider to differentiate its service from its competitors. “For example, if a proxy voting service is really sophisticated or the clearing service is of high quality, it does make sense to put a fee structure in place that allows you to charge a premium for this service,” she says. “A broader service array for different client segments is an important distinguishing factor for a provider. This way, the provider is not only able to offer the whole range of products, but is also able to offer stand-alone products”.

Looking ahead, Ellen van Krimpen notes that providers may look to price specifically for value added services such as fund administration, proxy voting and order-routing, and charge only a minimum fee for core custody services which are the basis for these valued-added services. This trend is already noticeable because ‘the competition’ focuses on fees for basic custody and settlement services. The added value products are the ones by which you can distinguish yourself from your competitors.

In adapting to this changing environment, KAS BANK is investing in the development of a range of new services for brokerage clients. “We offer a sophisticated order-routing system that allows clients to take advantage of the links that we offer to a number of European exchanges,” says Ellen van Krimpen. For broker clients, KAS BANK is also exploring the development of other administrative products. “For our subcustody clients, on the other hand, we are clearly focusing on the corporate action product, tax and, very importantly, on proxy voting. For our institutional clients, the emphasis is



on completing the full range of investment administration services.”

The product range that KAS BANK offers supports a wide choice of different instruments throughout the asset lifecycle. “Nowadays, we offer products that extend from the trading and the investment decision through to the financial reporting and investment administration,” concludes Ellen van Krimpen.

## Mellon Group

Patrick Costello, Global Head of Network Management at Mellon Group, highlights a number of factors that have caused his network team to refine their approach to risk management in the face of the tight costs environment that has been evidenced in the industry during the last four or five years. Firstly, he notes that the process of appointing and replacing subcustodians has become increasingly complex and time consuming over the decade. “While it probably took us three to four months to change agents in the mid-1990s, it was taking nine months or even longer by the late 1990s,” says Mr. Costello. The main reason for the longer time lines is that contract negotiation has become increasingly protracted. Both global custodian and agent banks have become more sophisticated regarding what is contained in those contracts. The implications for risk management are important. Mellon Group considers its ability to replace an agent, when standards dip below an acceptable level or when pricing ceases to be competitive, to be an important control point. “As the process of changing agents has become more cumbersome, the control of voting with our feet was at risk of eroding,” says Costello.

In response to this trend, and to an increasingly tight cost environment, the Network Management team at Mellon Group fashioned a strategy that employs two agents in as many markets as possible, while at the same time significantly consolidating the number of agents employed. The key to the central conflict of the strategy — more agents under contract in each market and fewer agent relationships to manage — is the use of multi-market agents.

Launched in 2002, the execution of this strategy is now complete. “By layering multi-market agents over one another, we have installed back-up agents in sufficient markets to account for over 98 per cent of our clients’ assets and reduced the number of agent relationships by over 50 per cent”, explains Patrick Costello. The installation of a back-up agent is known internally as ‘the Safety Net(work)’. “We have continued to operate in each market with a preferred agent, and we give that preferred agent our entire mandate,” clarifies Mr Costello. “The Safety Net(work) is a significant risk mitigator, while the reduced level of agent relationships has positively impacted our cost structure by increasing our relationship leverage and decreasing our overhead”.

Given that no agent bank wishes to be the runner-up at the beauty contest, what challenges did Mellon Group face in implementing this dual provider strategy? “We recognised that there is a degree of cost and effort involved in being a back up agent, albeit at a moderate level, and we expected that in most cases the agent would want to be compensated for that,” explains Costello. “However, I made it a central precondition when introducing this

arrangement that, under no circumstances, was the Mellon Group going to pay an agent just for sitting in the wings. Ultimately, the solution that we came up with was that the provider that we appointed to be our primary agent in Market A would also serve as our back-up agent in Market B. In this way, we ensure that each agent receives a healthy revenue stream in the markets in which it acted as our main agent.

Mellon Group’s ability to put this dual agent policy into practice has been reinforced by a discernible improvement in the standards of service offered by the leading multi-market providers in a wide range of locations. An advantage with appointing a bank with a multi-market capacity was that they were typically willing to serve as back-up agent in one or more markets, as long as they were appointed primary agent in others, notes Pat Costello.

Significantly, three years ago, there were few banks that genuinely met Mellon Group’s expectations of what was required from a multi-market subcustody provider. In the intermediate period, however, a number of banks have invested seriously in developing their product, such that they now offer a range and quality of service that is broadly in line with what Mellon would expect from a genuine multi-market subcustody offering.

Furthermore, a short distance behind this leading group, there is a larger group of providers that are also working hard to build their product into a multi-market service. The latter still have some distance to go to achieve this goal, but this trend is extending the choices available to network managers when considering appointing a custodian to service their business in multiple locations.

This is not to dismiss the service quality offered by the leading single market providers, however. “Some single market providers continue to provide outstanding service and we continue to take advantage of their service when they are the best agent in the market,” says Costello. “Against certain check points, a single market provider is at a clear disadvantage — for example, they may be more limited than a multi-market provider in the choice of locations they can select for their business resumption hot site, or they may face disadvantages in fee management through being unable to spread costs across multiple locations. However, some do continue to overcome these limitations by offering superior service and highly competitive fee schedules. Furthermore, a number of agents that have traditionally operated as single market providers, such as DBS in Singapore, for example, are now extending their services into neighbouring countries and are gradually developing a multi-market offering themselves.”

## Direct market access

Mellon Group currently clears its own trades in the US and Canadian markets. It was one of the last of the large global custodians to set up a self-clearing operation in the UK, establishing a self-clearing operation in London in March 2003. Patrick Costello reports that this initiative has proven to be highly successful for the Group and has exceeded the service and cost targets that were established for this project in advance. Subsequently, Mellon Group transferred its Irish securities processing through this same pipeline in November 2004.

With the withdrawal of ABN AMRO from the

Dutch subcustody market, Mellon Group also elected to bring its Dutch subcustody in-house in June 2005. Having weighed up the relative merits of appointing a third-party subcustodian or establishing its own direct link into the market, Mr Costello explains that Mellon identified significant advantages in going direct. It has been able to operate its Dutch custody facility through the banking licence that ABN AMRO Mellon holds in the Netherlands and it has been able to manage its operations via its London service centre. Consequently, it has been able to keep its costs down and has not found it necessary to establish additional offices or operations centres in the Netherlands.

### Pricing Models

In the area of pricing, Patrick Costello indicates that there is currently a significant gap between the fee structures he would anticipate from his subcustodians and those that he would like. “What I would welcome would be to see more flexibility in pricing formats, such that the agent can offer tailored fee schedules that are adapted more closely to Mellon Group’s needs as a global custodian,” he says. “However, what I expect is that such discussions will be very slow and that many agents will not be keen to engage in these conversations at all.”

Since he had his first exploratory conversation about fee formats in 1992, Mr Costello explains that he has evaluated the use of a range of different structures, but has found that it is typically the traditional formats that persist. “We have looked at formats where we pay only a transaction fee and no charge for safekeeping, and also where there is a safekeeping fee but no transaction fee,” he says. “In some markets, we have explored structures where the safekeeping charge is a flat fee, rather than ad valorem. We have also assessed formats where the safekeeping charge is defined by the number of line items.”

An interesting reflection on Mellon Group’s experiments with these different pricing mechanisms is that, typically, where it does employ a non-standard format, this has almost always been in circumstances where Mellon has made this a condition to win its business. “Not only has there been a degree of fear of the unknown and a reluctance to change,” says Costello. “Many agents also recognise that the traditional format typically works in their favour. Consequently, they fear a change that, they believe, may be detrimental to their revenue streams. Given this reluctance, reform has often been borne out of a moment of tension when the incumbent realised that it would have to adopt a new fee format if it was not to lose the business; or the incumbent was unwilling to change and the prospective agent adopted the new format in order to win the mandate.”

### Concluding points

In making the above points, Patrick Costello concludes that the agent bank community is broadly in good health and that rumours of its demise are somewhat premature. While the industry continues to talk of agent banks being ‘disintermediated’ by depositories and ICSDs, he notes that this will only happen if the latter develop a viable alternative to the job being done by the agent bank community currently. “On the one hand,

the industry is talking about depositories and ICSDs not being good at asset servicing,” he says. “On the other, it is constantly talking about these infrastructure entities disintermediating the agent banks. There is a fundamental contradiction here. If the latter are not good at asset servicing, how will they provide an alternative to what the agent banks offer that will be acceptable to the market?”

If, however, an alternative does emerge to the services currently delivered by the agent bank community, Patrick Costello has few fears that this will result in deterioration in service standards, or erosion in the level of protection given to client assets. “When the marketplace does offer an alternative solution, history has shown that this frequently represents a generational improvement on the service that preceded it,” he says. “Hence, as a global custodian, I have few worries that this may compromise our ability to fulfil our fiduciary duties to our clients.”

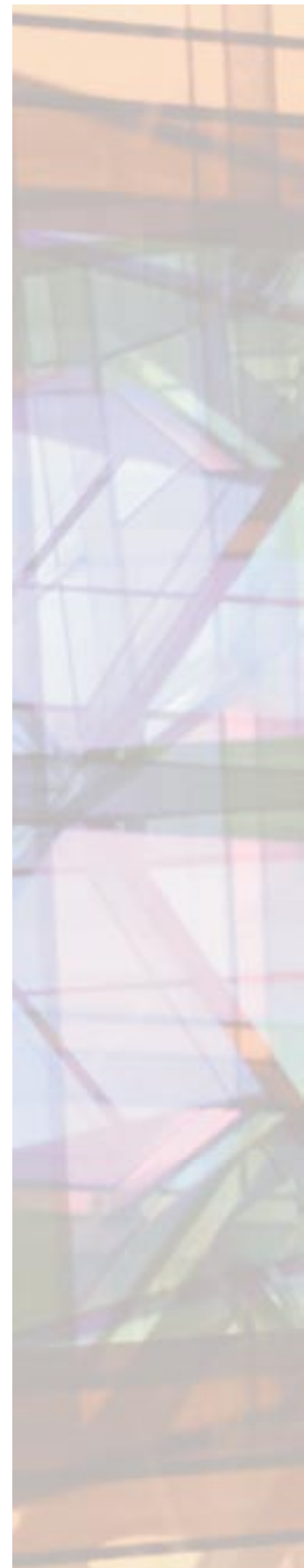
Within this environment, he is confident that the global custodians themselves are putting little downward pressure on the fees charged by agent banks. “It is true that, as global custodians, we are monitoring and responding to the cost reductions that are being offered by the subcustodian community,” he says. “A good network management team is ever watchful in making sure that its costs come down as its agents reduce their fees. We run an active fee management programme that keeps us abreast of opportunities that the market is delivering to us as a buyer. However, we are not ourselves driving pricing down through this mechanism — it simply puts us in a position to capitalise on the downward movement in fees generated by competition within the agent community.”

### Northern Trust

In managing its subcustodian network, Northern Trust retains its longstanding commitment to selecting the best provider in each market. However, Andrew Osborne, Head of Worldwide Network Management at Northern Trust, points out that the mechanics of agent bank selection have been reshaped in recent years by a number of factors. Firstly, the number of providers in some markets has reduced discernibly. The net result is that Northern Trust now uses a smaller number of subcustody providers to service a larger number of locations across its network. This has enabled the bank to leverage the broad relationships that it has established with regional providers to generate operating and cost efficiencies.

Secondly, and in parallel with the above, Northern Trust has been successful in attracting new business during this period — and the additional transaction volumes and assets under custody that this has generated has allowed the bank to benefit from improved fee schedules with subcustodian banks in its network.

Thirdly, subcustodians have continued to develop their service offerings and to improve their operational standards. In parallel with efforts to improve efficiency at the infrastructure level, and to harmonise market practice at the industry level, this has translated into improved cost efficiencies for the global custodian community and the client base that it serves.



### Network management as a risk management function

In navigating their organisations through this tight financial environment, the primary responsibilities carried by a network manager have changed relatively little. “In essence, network management is a risk management function,” says Andrew Osborne. “This is all about managing the risks that are generated when a client invests in an overseas market — and this clearly demands that we have structures in place to manage these risks effectively.”

The first element in securing this objective, notes Mr Osborne, is to have experienced teams of staff in place that are suitably positioned to manage these risks across the global network. Northern Trust benefits from having staff strategically placed to respond to the demands of the major time zones. Northern Trust manages the Asia-Pacific region from Singapore, the US and Canada with in-situ staff, and Europe Middle East and Africa (EMEA), and the non-North America markets in the Western Hemisphere, from London.

A second component is to ensure that the network management function is effectively supervised in coordinating these activities. Northern Trust’s network activities are supervised by its Subcustodian Oversight Committee, which is part of the bank’s credit and risk management chain, and is made up of representatives from senior management in a range of departments across the bank, including risk management, foreign exchange, operations, country credit, institutional credit and various business development teams, each of which have a direct interest in how the network function operates. This Subcustodian Oversight Committee meets on a monthly basis to review the activities of the network group, to ensure that risks are being managed effectively, and to support the continued enhancement of the applied risk-management techniques of the network process.

### Market access

Northern Trust employs an agent bank to service its business in all markets across its global network, apart from the US, Canada, the UK and Ireland. However, Andrew Osborne makes the point that the bank will not allow ideology or dogma stand in the way of what it feels to be the most appropriate business model for servicing clients’ business in any individual market.

In several markets, it has made sense for Northern Trust to self-clear for strategic reasons, explains Mr Osborne. “We have been self-clearing in the US and the UK for a number of years, and it is logical for us to self-clear in Ireland, given that we are a CREST member and can do so off the back of our London-based business. We moved to self-clearing in Canada in 2000 and this has proven to be very successful, enabling us to enhance the way that we service our clients’ portfolios.”

In evaluating the potential for self-clearing, Osborne makes the point that it is necessary to evaluate the associated benefits and costs associated with each particular situation on a market-by-market basis. “In the Canadian market, the advantages of self-clearing were reinforced by the fact that we could run our operations from our Chicago offices and did not have to build our own in-situ operation in Toronto. As such, we were able to leverage off the scale and

self-clearing expertise offered by our US operation and to extend this capacity in the Canadian market, supplemented with support staff in our Toronto office.” This option also increased Northern Trust’s flexibility in terms of pricing and service. “In some markets that have just one or two providers, one’s choices, in terms of price and service, can become a little limited,” says Osborne. “Given that we were also working towards the strategic objective of expanding our book of business among domestic Canadian clients, the move to self-clearing represented a logical option for Northern Trust at this time.”

This said, the self-clearing option can be complex and costly when we look to continental Europe. Consequently, Northern Trust has not set its stall out for a wholesale transition to self-clearing in the near future. “In the majority of markets, we remain enthusiastic advocates of the third-party subcustodian model,” explains Mr Osborne. “We feel that this model typically provides us with the best of both worlds: we are working with subcustodians that have substantial scale and volume and this translates into benefits for us in terms of costs. We are also able to take advantage of the expertise and market information that a subcustodian can supply from the local market.”

In contrast, there are invariably substantial overheads involved when building an operation to self-clear. If one wishes to self-clear in any of the continental European markets, one is likely to encounter a range of challenges related to connectivity and language that would typically necessitate opening a local office and maintaining on-the-ground staff-support in the market concerned. Given the high costs of real estate and staffing in many financial centres, this option may be prohibitively expensive. By eliminating an agent bank and plugging directly into the infrastructure, one would also take on new levels of risk, particularly on the asset servicing side.

Given these dynamics, Northern Trust continues to monitor market developments on a case-by-case basis. “The key questions are: (i) will self-clearing allow you to process your business more efficiently? (ii) Will it allow you to do so at better cost? (iii) And will you have the risk management structures in place to manage the associated risks at least as well as a third-party subcustodian?”, says Osborne.

If these criteria are each met, Northern Trust will consider the option of reviewing its mode of market access. “Were there in the future to be an integrated and efficient pan-European clearing and settlement mechanism, then we would look more closely at the self-clearing option,” Osborne adds. “In this situation, it is not unthinkable that we would look for ways of plugging directly into this facility and becoming a self-clearer across Europe.” However, the dynamics of the self-clearing process, and the asset servicing component necessary to back this up, would have to meet the stringent criteria outlined above before we would feel comfortable in doing so.”

### Pricing models

Given the growth in business volumes that leading global custodians are holding with their subcustody agents, Andrew Osborne makes the point that the industry will soon need to rethink the pricing models employed by subcustodians to charge for their services. “As the asset values that we

hold with a subcustodian increase, the value at risk is not increasing at a proportionate rate,” he suggests. “However, this is not reflected in current fee structures, where global custodians generally currently pay an ad valorem fee based on the valuation of the assets that they hold with the agent. We have now got to the stage where we need to break this connection between asset values and ad valorem fees, potentially moving to a situation where fees are capped, or margins at the top end are reduced to the level where global custodians are really picking up no more than the streetside fees. Although this type of graded scale exists to a degree, the global custodian is still paying a high margin at the top end compared with the additional costs borne by the subcustodian for servicing these assets.”

Andrew Osborne is aware that there is likely to be resistance to these changes from sections of the subcustodian community. “As network managers, and as an industry, it is not in our interests to force our subcustodians out of business and we are well aware that subcustodians do need to make effective returns from their services in order to continue as a viable business,” he says.

However, there is also intense pressure on the global custodian community through the squeeze on fees that global custodians are being paid by their own investor clients. Mr Osborne feels that these pressures will continue to be reflected down the securities processing chain. “We are looking to be proactive in adapting to these cost pressures and managing these effectively along the value chain. From the subcustodians’ perspective, their activities remain a high volume, low margin style of business and they have limited value added services that they can offer to support their revenue flows. As such, subcustodians will be looking particularly to introduce more efficient methods of processing and, in some instances, to boost efficiencies by setting up dedicated processing centres in some of the more cost-efficient locations. As we push them to take costs out of the system, they will need to be looking closely at their systems in order to identify how they can reduce costs in the markets in which they are active.”

### Fiduciary standards

While these costs pressures have forced global custodians and subcustodians to re-examine internal and external structures closely in search of potential cost-savings, Andrew Osborne makes the point that the cost reductions being passed through the value chain have had no impact whatsoever on Northern Trust’s ability to meet its fiduciary obligations. “Clearly, the bank’s reputation, and the standards demanded by our clients, will support no weakening of the fiduciary standards that we extend to these customers,” notes Osborne. “Furthermore, there are regulations in place that will not allow any deterioration in standards in this area. Just as subcustodians are under pressure to find creative new ways to deliver better service at lower cost, similarly global custodians are under pressure to find more effective methods of identifying and managing risk across our network.”

In concluding, Mr Osborne makes the point that the standards of service offered by the subcustodian community remain high, despite the squeeze on its revenue stream that this community has experienced in recent years. “When buying subcustody services these days, you are buying

different levels of excellence from the main providers,” says Osborne. “They have to be efficient, they have to be good. The costs of not being able to do the job well are extraordinarily high these days, given the value at risk that we all carrying. Subcustodians that cannot meet these standards have little opportunity to attract and retain business in today’s custody and clearing environment.”

### State Street

Regardless of where a financial organisation sits in the chain of custody, there is always a desire to optimise price and service, notes Bob Almanas, Senior Vice President and Head of Non-US Operations — which also includes Network Management — within Global Services at State Street. With that comes associated cost pressures and new service demands and it is typically a challenging task to find an appropriate balance between the two.

### Economies of scale and new service demands

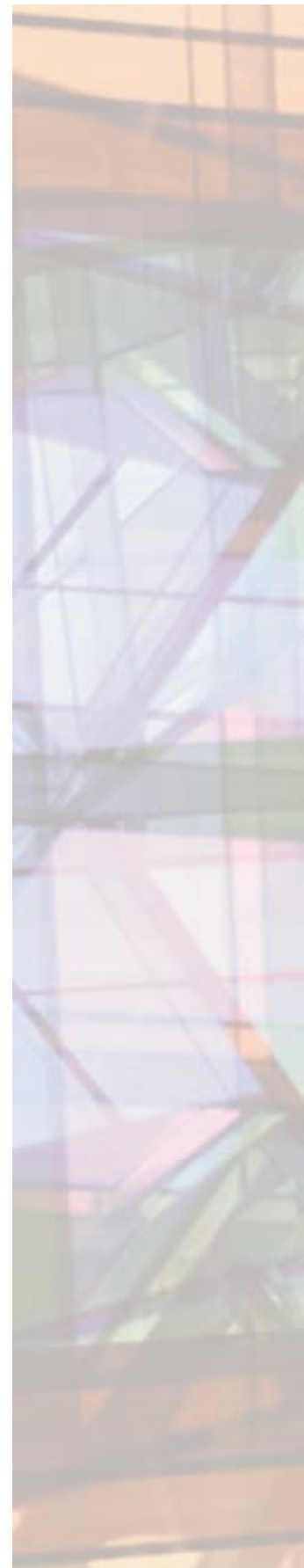
State Street has been well positioned over the last four or five years to improve its cost efficiencies, having experienced significant organic growth during this period and having significantly increased its assets under custody through the acquisition of Deutsche Bank’s Global Securities Services business.

This growth has shaped State Street’s business development at a number of levels. Firstly, it has provided greater economies of scale that have allowed the bank to leverage opportunities across its network of subcustody and cash clearing agents. However, Almanas is emphatic that the focus has been on negotiating cost reductions with its agent banks in a prudent manner, such that pricing efficiencies are never secured at the cost of a reduction in safety and service quality.

Secondly, with this expansion, State Street has taken on a broader customer base and this has laid a series of new service requirements at the door of the operations and network management team. “For example, in the German market, we have taken on new segments of business that are relatively specialised to the domestic market,” says Almanas. “These have presented types of transaction events and tax requirements that would be rarely encountered by operations groups or a Network Management team focused primarily on managing cross border business.” One example is *schuldshendarlhens*, a promissory note widely held by German insurance companies. These assets are held as physical paper and have some unique servicing characteristics. As a result, State Street’s network team worked closely with Deutsche Bank, its German subcustodian, in order to draw on the specialised knowledge that the latter has in servicing these instruments.

### Pricing Models

Mike Cuneo, Director of Network Management and Correspondent Banking at State Street, observes that, although there has been discussion at a theoretical level of the potential benefits of moving to new pricing structures, in practice most agent banks are still inclined to offer tariff structures based on asset value (an ad valorem custody fee) and activity levels (a transaction fee) when entering into an RFP exercise or fee negotiation with State St.





This can probably be explained by a number of factors. Firstly, this standard fee model is what many agent banks assume that the global custodian is looking for when entering into fee negotiations. Secondly, it is relatively simple to administer — the standard fee agreement is easy to generate from a subcustodian’s standpoint and easy to validate for a global custodian customer. Thirdly, this may be driven by fear of the unknown. As a subcustodian, it is hard to know in advance what the impact will be on its revenue flows of entering into an entirely new fee structure with its clients.

Mike Cuneo indicates that his network team has, in specific cases, developed alternative tariff structures for selected components of the fee agreement with certain subcustodians. However, he points out that this type of innovation works best when there is a high level of mutual trust between the agent and the global custodian, since neither can anticipate with absolute certainty how this will work out for either party. Hence, it requires a high level of professionalism to ensure that the structure is workable and mutually beneficial.

**Implicit and Explicit Costs**

State Street approaches any fee discussion with the fundamental premise that there are two basic components of cost — an explicit cost and an implicit cost. Bob Almanas explains that the explicit cost is the headline figure that State Street actually pays to the agent for the services that it receives. However, State Street as a global custodian may also need to bear additional costs, which Almanas labels implicit costs, to ensure that services delivered by the subcustodian are compatible with State Street’s internal structures and meet the standards of service that it requires. This may refer, for example, to costs of employing additional technology or staffing necessary to work with the subcustodian concerned, the costs borne in repairing failed trades and operating errors, and opportunity costs of poor cash management. In sum, the cheapest fee quoted on a fee proposal may not be the cheapest when the overall costs of transaction processing and asset servicing are calculated in full.

Although, some agents may attempt to ‘buy’ business by offering low headline fee structures, Bob Almanas points out that there can be a high level of risk, and substantial additional costs, associated with an agent’s inability to perform to the standards that State Street requires. “We direct detailed attention to the potential cost benefits and penalties of bundled and unbundled pricing schedules,” he adds. “We sometimes encounter pricing schedules that are several pages long and that, on the face of it, may look cheap. However, when we pass these through the sophisticated sensitivity models that we have developed, and that are available on the desktops of each of our network officers, then we sometimes find that these fee schedules are not nearly as competitive as they appear in the first instance.”

**Market access**

While State Street keeps a close eye on the enhancements that infrastructure providers are making to their service offerings, and constantly re-evaluates the potential benefits that may be realised by self-clearing and self-settlement, Mike Cuneo points out that State Street continues to run

a ‘subcustodian-centric’ network business model. Indeed, of the 103 markets in which State Street offers custody services, it employs an agent bank in 100 of them, the only exceptions being the US, Canada and the UK, where it processes its own settlement and asset servicing activity.

Utilising a network of agent banks for subcustody and cash clearing has been State Street’s approach historically and this model has worked very well, reports Mike Cuneo. “Having said that, however, we are closely watching the business dynamics across the industry to monitor what is happening in the areas of regulatory harmonisation, standardisation of market practices, and the consolidation of infrastructure. At this stage, I do not think that it is entirely clear to anyone who will be left standing when the music stops. Consequently, we have not felt it necessary to make any dramatic changes to our approach to network management so far. However, we retain a willingness to change both tactics and strategies as appropriate to ensure continued service excellence and the highest fiduciary standards.”

Bob Almanas makes the point that historically it has not been State Street’s strategy to offer traditional subcustody on a third-party basis, even in the markets where it acts as subcustodian for its own service needs. “We operate on a high scale, believing that allocating our capital to the business we are already in, and the new business lines we are developing, will give us better returns on our investment than plugging into infrastructure or becoming an agent ourselves,” he says. “But here again, we never say never. We are intent on staying sufficiently nimble to ensure that we can change our approach to make sure that we continue to deliver the best possible price/service mix to internal and external customers.”

In conclusion, the equation is constantly driven by State Street’s efforts to find a balance between risk and value — and Almanas intimates that these issues continue to be discussed on a daily basis within the operations and network management team. The demands that global custodians place on their subcustody agents have continued to increase and, in recognition of this, both Almanas and Cuneo sound encouraging notes that leading agents have continued to refine their service offerings in order to deliver a more robust and cost efficient service to their clients. “The fact that agent banks in many markets are caught between a rock and a hard place — in other words, squeezed between the demands of customers on one side and the challenges of interacting with the local infrastructure (including infrastructure price hikes in some cases) — is a major challenge for subcustody organisations,” says Mike Cuneo. “We are sympathetic to the pressures agent banks face, but there is absolutely no chance, in light of this, that we are going to lessen our service requirements. Indeed, quite the contrary. We continue to reinforce our service expectations, making them more precise and raising the bar incrementally over time. However, we do so with an eye to new ideas and to novel approaches that can be mutually beneficial to both sides.”

“On balance, our strategy is underpinned by the principle that we will never compromise on fiduciary standards, regardless of the price discussion involved,” concludes Bob Almanas. “We have never allowed the compromise of our fiduciary obligations in order to reap savings.” ■