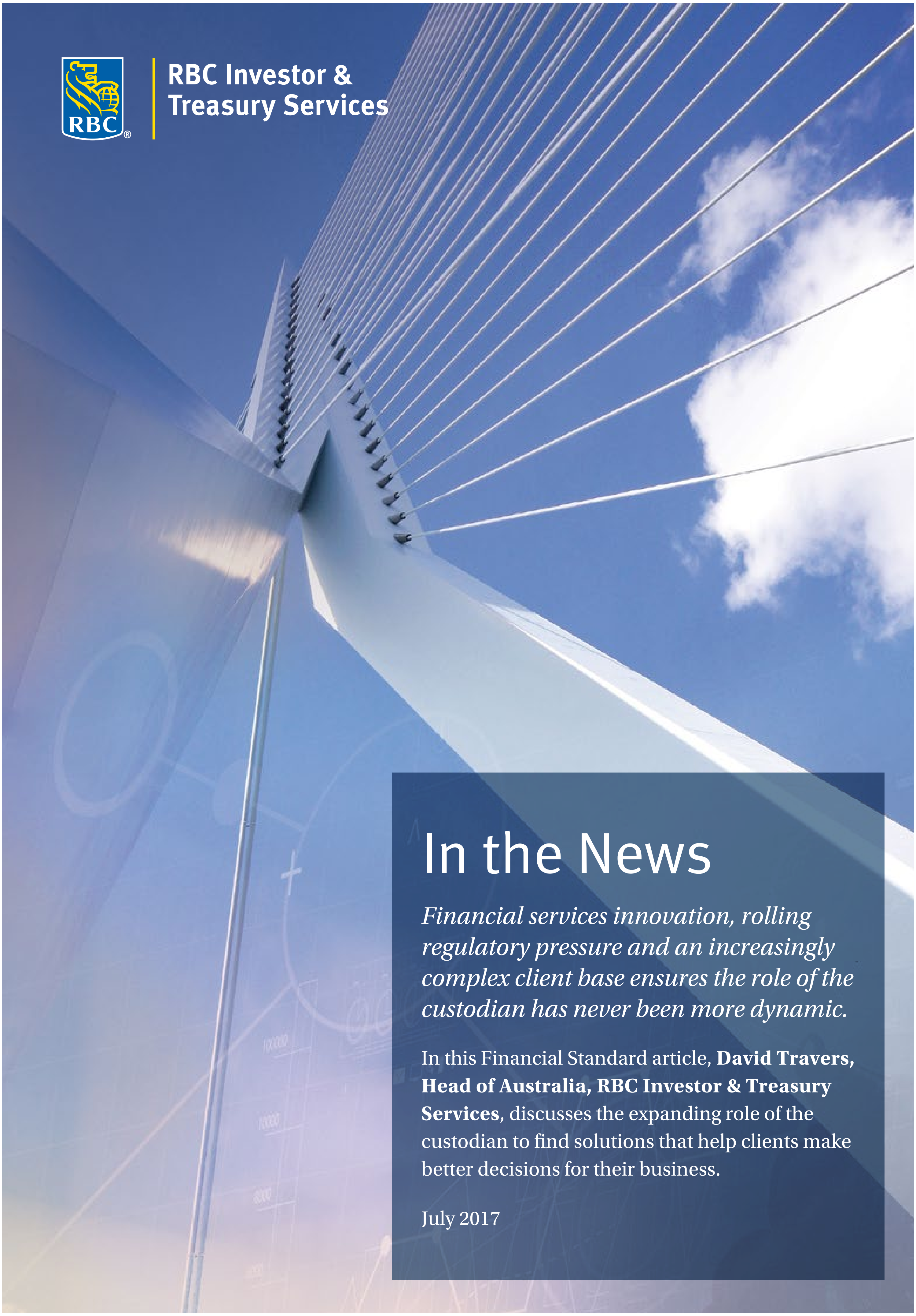

RBC Investor & Treasury Services

In the News

Financial services innovation, rolling regulatory pressure and an increasingly complex client base ensures the role of the custodian has never been more dynamic.

In this Financial Standard article, **David Travers, Head of Australia, RBC Investor & Treasury Services**, discusses the expanding role of the custodian to find solutions that help clients make better decisions for their business.

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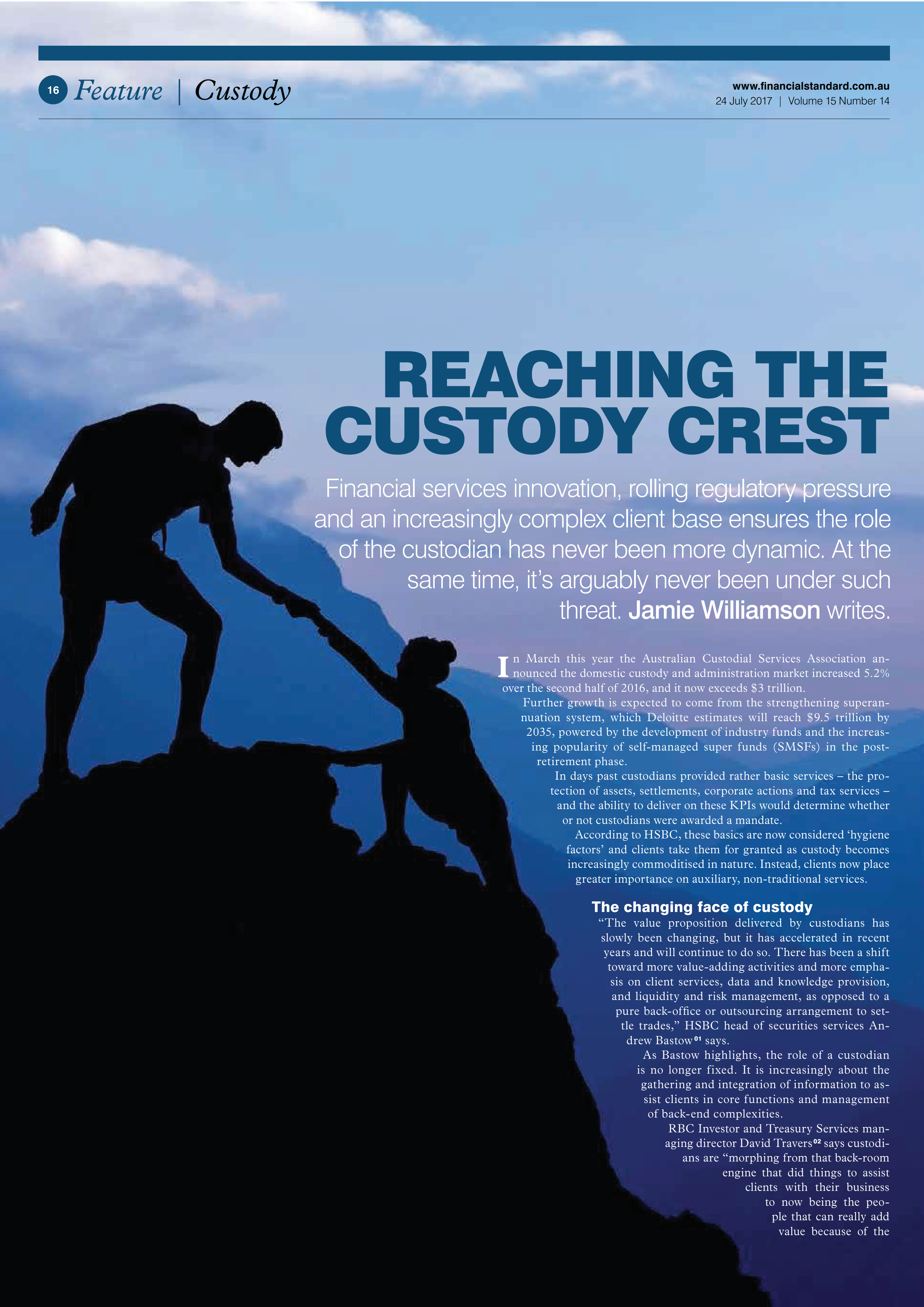

REACHING THE CUSTODY CREST

Financial services innovation, rolling regulatory pressure and an increasingly complex client base ensures the role of the custodian has never been more dynamic. At the same time, it's arguably never been under such threat. **Jamie Williamson** writes.

In March this year the Australian Custodial Services Association announced the domestic custody and administration market increased 5.2% over the second half of 2016, and it now exceeds $3 trillion.

Further growth is expected to come from the strengthening superannuation system, which Deloitte estimates will reach $9.5 trillion by 2035, powered by the development of industry funds and the increasing popularity of self-managed super funds (SMSFs) in the post-retirement phase.

In days past custodians provided rather basic services – the protection of assets, settlements, corporate actions and tax services – and the ability to deliver on these KPIs would determine whether or not custodians were awarded a mandate.

According to HSBC, these basics are now considered 'hygiene factors' and clients take them for granted as custody becomes increasingly commoditised in nature. Instead, clients now place greater importance on auxiliary, non-traditional services.

The changing face of custody

"The value proposition delivered by custodians has slowly been changing, but it has accelerated in recent years and will continue to do so. There has been a shift toward more value-adding activities and more emphasis on client services, data and knowledge provision, and liquidity and risk management, as opposed to a pure back-office or outsourcing arrangement to settle trades," HSBC head of securities services Andrew Bastow[01] says.

As Bastow highlights, the role of a custodian is no longer fixed. It is increasingly about the gathering and integration of information to assist clients in core functions and management of back-end complexities.

RBC Investor and Treasury Services managing director David Travers[02] says custodians are "morphing from that back-room engine that did things to assist clients with their business to now being the people that can really add value because of the

01:
Andrew Bastow
head of securities services, HSBC

02:
David Travers
managing director, RBC Investor and Treasury Services

03:
David Braga
head of securities services Australia/New Zealand, BNP Paribas Securities Services

data required to be able to support businesses going forward."

"At the core of what we do is the information we hold for clients around how their investments are held and how they're performing, and that data is increasingly something that clients are looking to use in better ways."

To this end, custodians are wielding greater influence over client business and investment decisions.

BNP Paribas head of securities services Australia/New Zealand, David Braga[03], says that in the low return environment asset owners are turning to investments that would have traditionally been characterised as 'exotic'.

"As a back-office provider that means we need to be able to support a wider range of assets, particularly when it gets to the complex analytic reporting needs. We've had to up the ante on areas like derivative reporting, unlisted asset reporting, risk reporting and performance reporting – that's where we've been putting a lot of the work in," Braga says.

In line with this BNP Paribas Securities Services adopted a new means of reporting on ESG factors, bringing together the holding data and universe of client money to be bridged against benchmarks to gain a greater understanding of existing and potential investments.

"We're not representing whether those ESG factors are good or bad – that's up to them to decide – but if you think about the data complexity, we're answering those questions for them…We don't ever want to be advising clients on what to do because that isn't what we do, but we do want to be informing," Braga says.

"The more knowledge we can give them about what's going on in their portfolio, fingers crossed, they'll be well placed to make the decision that they want to make."

HSBC head of global custody John van Verre agrees, saying global shifts in asset allocation will encourage custodians to become knowledge providers.

"Investing in emerging and frontier markets presents significant challenges for investors. Deep understanding of local and cross-border regulations, law, tax and other relevant matters will be critical to helping clients achieve their strategic objectives," he writes in the paper 'Custody in 2025'.

RBC's Travers notes this is perhaps having the biggest impact on the client/custodian relationship. Traditionally the custodian's role would be around reporting a unit price to clients every day. Now custodians are closer to the client.

"Clients today are looking to understand how their investments will perform in risk situations in the market. They want to know if there's a systemic risk in the marketplace, how would they perform? What are the operational risks occurring in their funds when there is a shock to the industry?" Travers says.

The more knowledge we can give them about what's going on in their portfolio, fingers crossed, they'll be well placed to make the decision that they want to make.

He adds that being able to provide the data RBC holds, which is then matched against trending information from non-traditional sources such as Facebook and Twitter, helps organisations understand the risks in their portfolios and enables them to make better business decisions around how to react in volatile times.

"You wouldn't construct a portfolio around the information we have, but you could use it as another data point when you are constructing a portfolio. Custody is about creating solutions and services that help our clients do what they're already doing, but better," he says.

J.P. Morgan managing director custody sales and client relationships Australia, Bryan Gray[04], emphasises this is particularly beneficial to the increasing number of superannuation funds working to internalise investment capabilities. AustralianSuper, with more than $120 billion in funds under management, stands as J.P. Morgan's biggest super fund client and is a prime example.

Having ramped up its efforts to bring investment in-house in recent years, Gray says the greater focus placed on data provision as part of J.P. Morgan's offering has assisted AustralianSuper immeasurably.

"As they continue to build an investment team over time, what they look to us to do is to support that team on a day-to-day basis. That was a big piece of work that we did with them, to provide a middle-office service that works with the counterparties they deal with to equip them with the information that their internal traders need to invest," Gray explains.

The weight of regulation

The value placed on such in-depth, comprehensive data is significant, not only for investment decisions, but also for compliance reasons. Ongoing and increasing regulatory pressures have resulted in substantial change across both custody and the wider financial services sector.

"Most notably, post-GFC, is the urgency around some of the regulatory changes we've seen as governments have wanted to get their arms around the financial sector. It's really important that we talk about global regulation too, because many of our clients are institutional investors investing globally and are impacted by the likes of MIFID II and Dodd Frank," Northern Trust managing director Australia and New Zealand, Madeleine Senior[05] says.

At home in Australia, the Attribution Managed Investment Trust legislation was passed into law in July 2016, introducing new rules for the taxing of income derived through AMITs. It also provides qualifying MITs with greater flexibility around the distribution of trust income to investors and deems them to be fixed trusts for tax purposes.

"There's been a big focus on AMIT this year. While it's an opt-in, organisations have been working to comply with this before missing out on some of the transitional rules. We've been doing a lot of work with our asset manager clients to support them as they rebadge their managed investment funds for AMIT and understand the new associated tax regime," Gray explains.

ASIC's RG97, which focuses primarily on transparency and costs, and RG133 on the safekeeping of securities, are also expected to have an important impact.

As for RG133, last month 21 responsible entities and custodians reviewed by ASIC were found to have generally poor levels of understanding and compliance with the guide.

At the time, ASIC commissioner John Price said: "The custody – or safekeeping – of assets is a critical function. Without appropriate safeguards by the asset holder, either a responsible entity or a custodian, there is a potential threat to investors' assets. Adequate resources and an appropriate risk management framework are therefore necessary for asset holders, to ensure that their safekeeping and related functions are properly performed."

Northern Trust's Senior says in terms of regulation, change will continue to happen. She says the demand for transparency will also increase, "so clients across the world – and especially in Australia and Asia – are looking to their custodian for faster, granular, and much more enriched data than they were 10 years ago."

Being able to fulfil the evolving needs of a custody client doesn't come cheap though, with continual investment in technology required. Northern Trust allocates around $1.3 billion annually to technology, both upgrading existing technologies and investing to ensure it is always innovating and insulating its clients.

"We continue to invest in the right people, technology and product to make sure that we are insulating our clients as far as possible from these new requirements, because if we have the data anyway, it makes sense for us to use it as a solution for some of these new reporting requirements," Senior says.

She adds that technology has and will continue to play a significant part in the evolution of our industry, and that could be via robotics, artificial intelligence or blockchain. Robotics is an area brimming with opportunity for financial services, with the automation of repetitive and laborious processes one of its biggest drawcards.

04:
Bryan Gray
managing director, custody sales and client relationships Australia, J.P. Morgan

05:
Madeleine Senior
managing director Australia/New Zealand, Northern Trust

06:
Daniel Cheever
head of client management, State Street Australia

J.P. Morgan currently has 35 robots operating across its corporate and investments bank in Asia-Pacific and is exploring a further 250 similar solutions in its offshore Centre of Excellence for Robotics in the region.

Reports traditionally sent out to clients by an individual on a regular basis can now be sent out at the same time every single day without limitations, such as annual leave or sick days. The process itself becomes easier, thereby improving service.

Robotics proves further efficiency as it can be integrated into existing systems, according to RBC's Travers.

"More and more organisations are looking at how they can take the platforms they already have in place and make them more efficient, and robotics is a way of doing that where you can apply an overlay of intelligence that can utilise existing applications better than previous with manual or human interface," Travers says.

Blockchain: Friend and foe

While solid legislation outlining how blockchain will be regulated is yet to be developed, it is also poised to transform financial services. It's on everybody's radar and has the power to revolutionise entire aspects of a custodian's business model. In that sense, it's fair to say it stands as both an opportunity and a threat for the sector.

Blockchain, otherwise known as distributed ledger technology (DLT), is used to maintain a transparent, continuously growing list of records, including transaction processing and history of provenance. By its very nature, blockchain seeks to disrupt the primary function of a custodian – the safeguarding of assets.

For this reason, it can be argued the custodial industry has always been vulnerable to disintermediation. However, HSBC's van Verre argues that the adoption of blockchain would significantly advantage custodians, writing that it allows for "one version of the truth."

He describes blockchain as a golden source that would work across the entire value chain, providing access to relevant information on a real-time basis.

"The benefits of a single book of records are obvious. They include shorter settlement cycles; cost reduction; full straight-through processing; the removal of reconciliation processes; and fewer settlement failures…The entire matching process can take place within this closed community, turning settlements into an internal book transfer. This will support a shortening of the settlement cycle to T+1 or even T+0," he writes.

State Street is also encouraged by blockchain, seeing it as a means of solving complex problems. State Street Australia head of client management Daniel Cheever[06] says the firm is looking internally and also to clients to "understand what the solutions are that we need to find."

"And [we're] experimenting to see whether blockchain is the solution for those problems. We're excited by it's potential."

J.P. Morgan is exploring how blockchain can best be applied in its custody operations, having already conducted proofs of concept. In April it announced the successful completion of a pilot, employing blockchain to enhance global proxy vote transparency in partnership with Broadridge Financial Solutions, Northern Trust and Banco Santander. The firm is also currently creating its own blockchain on the Ethereum platform, called Quorum.

J.P. Morgan APAC executive director, global technology strategy, innovation and partnerships, Benj Roberts says: "When it comes to blockchain, the key piece is around removing friction from financial services. Right now, there is a lot of collateral required to be kept on account as different transfers are occurring, so the aspect of immediate transfer and much shorter settlement times is quite key in achieving that."

Adding to the hype is news that the ASX is on track to formally decide by late 2017 as to whether blockchain is to serve as a suitable replacement for its CHESS system, having completed a prototype of a replacement last year based on DLT.

However, the time it has already taken for the ASX to reach this stage and the estimated time and effort it would take a business to implement the technology has some players in the custody space holding out before placing too many eggs in the blockchain basket.

Travers believes the excitement around blockchain is premature, saying that projects capable of supporting organisations of scale, such as RBC, will take quite some time to evolve.

"Blockchain will certainly have its uses, but it's probably got a long tail on it at the moment. We still need to figure out how to deploy blockchain in an appropriate and secure way, but with enough capacity to process the number of transactions that go through the financial markets," Travers says.

For HSBC's Bastow, the impact of blockchain is two-fold. While the added capabilities around crypto-currencies and digital identities will broaden the services that can be offered by custodians in future, he says it would be at the expense of narrowing what is offered by the industry today.

"It could be because blockchain disintermediates custodians from that particular aspect of business, or because of increased competitiveness as it will be able to be commoditised at a very low margin. I don't think that custodians will disappear though, because they do offer other things that maybe they aren't actually charging for today," Bastow says.

One challenge facing custodians when it comes to the integration of robotics and artificial intelligence technology is that it is somewhat oxymoronic in nature. Why? Investment in technology is higher than ever and the safekeeping of assets and settlements stand as the two primary, chargeable services that custodians provide. However, the fact that safeguarding now virtually consists entirely of maintaining electronic records means costs have declined and this is reflected in a decrease in value-based fees.

> *Clients across the world are looking to their custodian for faster, granular, and much more enriched data.*

"We're trying to digitise a lot of our operational work and robotics is a great way of growing scale and finding efficiencies, and producing automation. In a world where there are a lot of fee pressures for our clients, we need to look to lower the cost of service delivery and better technology will be a key strategy in that," State Street's Cheever says.

Bastow says custodians need to look at devising smarter pricing structures, believing that the current fee model based on the value of assets will disappear, and a consolidation of services – perhaps even of custodians – will be required.

"Custodians charge very little or nothing for other services that they already provide – and will provide more of in the future. These include covering the risk of asset loss; providing liquidity and credit for contractual settlement; and providing information, including extended data services," he says.

Despite this level of change both on the horizon and at their doorstep, custodians are adamant that they will likely continue to play a vital role in future, albeit a different one from today.

"Custody has been ever evolving and changing, but to date these changes have not fundamentally altered the shape of the value chain or custodians' business models. In contrast, the changes we are now starting to see happen are much more fundamental and will change the role custodians play in the overall value chain," HSBC's van Verre writes.

For now, State Street isn't viewing any innovation as a threat.

"I don't worry about that. I think a lot of what is required of a custodian still needs significant scale and we bring that scale to the table to be able to invest in those in a meaningful way," Cheever says.

Equally, BNP Paribas' Braga believes that the scale required to significantly disrupt the custody industry will be difficult for newcomers to achieve, ultimately leaving the custodians to explore innovation for themselves.

"Looking forward, it will be the custodians disrupting themselves. All we need is to ensure that we are well placed to succeed as the industry changes over time, and that's about having the right domain knowledge and cultural environment, where everyone is going to work well together to get things done," Braga says.

One thing that is certain is that standing still is not an option for custodians. **FS**