Financial Markets **INSIGHTS**

Evolution, not Revolution for Custodians

The Realization Group

ASCENDANT STRATEGY

Evolution, not Revolution for Custodians

Restructuring the business model of global custodians has been compared to changing a jet engine in mid-flight.

Whilst the cost pressure on the capital markets industry has been well publicised, less has been spoken about how the custody business needs to evolve in the face of this changing dynamic. Reliance upon the traditional value proposition of 'bricks and mortar custody' will no longer suffice in a world where clients are looking to service providers for more innovative, cost effective and value-added solutions in support of their own objectives. How should custodians position themselves to maximise opportunities to progress further up the post-trade value chain? Custodians have safeguarded traditional financial assets but how should they prepare themselves for the new world of protecting digital assets or security tokens?

In this Financial Markets Insights report, **Ali Rutherford** and **Rick Seaberg** of Ascendant Strategy; **Rob Scott** of Commerzbank; **Mark John** of BNY Mellon; **Matt Ruoss** at Scorpeo and **Virginie O'Shea** of Aite Group talk to The Realization Group's Mike O'Hara & Shanny Basar about the challenges that global custodians face and how they can get the most value from their investments to gain a competitive edge.

Legacy Infrastructure

A major issue is that global custodians have built up their core infrastructure over more than forty years and it is difficult to update these legacy systems to meet today's digital requirements, especially as over two thirds of their costs are due to people and process. **Rick Seaberg**, consultant partner at Ascendant Strategy, explains that custodians have needed to invest to meet new regulatory, compliance and risk requirements over the last five years instead of spending to make their business more efficient and to improve client service.

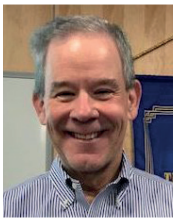
Seaberg says: "The clients don't see that investment, because it's a 'must-have' just to keep operating. It's larger and more pronounced for some custodians, given the number of back office systems they have and all of the surrounds that built up over the years."

As a result, it is very expensive to change legacy infrastructure and few custodians have been able to take a step back and look at their process from end-to-end to come up with a different operating model.

"It is like changing a jet engine in flight. You have got to find ways of improving processes, making it easier for the custodians' own people to serve clients better," Seaberg adds.

The legacy infrastructure means that it can take between a year to 18 months to onboard a new client. This adds to cost pressures as typically, the custodian does not get paid until the customer has been converted. In addition, when a client takes on a new customer they also may have to take on some of the customer's technology.

"It is not just in terms of moving the assets, people and processes, but time to market," says Seaberg. "The costs of obtaining a new client have become very expensive so rather than spending money on improving the service experience, custodians are stuck migrating customers onto standard systems, which are getting older and older."



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Rick Seaberg, Ascendant Strategy

Virginie O'Shea, research director at global research and advisory firm Aite Group, says custodians have legacy transformation on their radar but these will be long-term projects that last multiple years. In addition, each custodian must decide where to make investments according to its own strategic priorities.

"Some custodians are actively building out their front-to-back technology capabilities, while others are bogged down with regulatory compliance projects in Europe related to CSDR (Central Securities Depositories Regulation) and ongoing tweaks to existing regulatory regimes," she says.

CSDR – A Case in Point

The impending CSDR regime underlines the challenges faced by most custodians – the European Union regulation that goes live in September 2020 – who will have to work with their clients to increase settlement efficiency. The key challenge is that CSDR mandates how failed trades are settled rather than using the voluntary mechanisms that the market uses currently.

Settlement efficiency will become critical as CSDR mandates how failed trades are treated, rather than using the current voluntary mechanisms.

Mark John, Director at BNY Mellon's Clearance and Collateral EMEA| division, explains that despite modern technology, a huge amount of transactions fail for very simple reasons, such as incorrect settlement instructions.

He says: "You are going into the CSDR regime where settlement discipline will start hurting financial firms in the pocket. Knowing your client's activity and working with them more closely will be necessary in the new regulatory world."

By being able to provide insights and intelligence to the settlement flow, custodians can mitigate the cost of the regime by helping clients proactively manage their settlement risk. But to do this effectively requires availability of data and application of analytical tools to provide meaningful insights to it – all of which is extremely challenging based on infrastructure limitations surrounding where data is held and processed.

This example highlights the challenge faced by the industry – the positioning that a custodian maintains within the marketplace provides opportunities to progress further up the value chain for the client. As an example, because trades can fail due to a lack of liquidity in specific securities, lending these securities offers opportunities to provide additional servicing. John adds: "A custodian may be able to lend those securities and plug a liquidity gap to help the market start to function normally again. These are the kind of services that make custodians more relevant in the eyes of clients."

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Mark John, BNY Mellon

But the challenges of legacy architecture mean resource allocation internally within custodians is often heavily skewed towards 'lights-on' processing, limiting the capacity to develop and deploy these higher value services. As a result, for many the workload in support of implementation of the new settlement regime may well force some to consider how they allocate an increasingly limited pool of resources.

Rob Scott, senior banker – institutionals at Commerzbank, says the demands of CSDR could lead to custodians reviewing the value of highly inefficient clients which have poorer settlement and control practices which in turn lead to expensive failures.

"For clients that are highly non-STP, it will be necessary for Custodians to work with them to improve their overall transaction flow. The alternative would lead undoubtedly to higher overall charging," he says.

Risk versus Reward

The commoditised nature of the traditional custody model has historically made one of the main competitive differentiators breadth and scope of market offering. Maintaining a large, global presence has been essential for winning mandates and whilst custodians have centralised their processing in certain locations, local staff are still needed for their expertise.

Scott explains: "The primary reason that clients employ you in local markets is because you have the right level of experience and expertise. You are expected to represent the client in that market in a positive manner with the right levels of governance, risk controls and asset safety, as well as the lobbying of interests."

Operating in local markets has always been expensive to service and certainly, given the "race to the bottom in fee pools" experienced over the past decade, has resulted in larger Custodians demanding a more partnered and balanced approach. Instead of clients splitting markets across multiple custodians, Scott points out that there has been more concentration in some cases, or development of other commercial opportunities in order to balance the risk vs reward.

He highlights that sub-custody continues to have its commercial challenges, as with all areas of service provision. "There is continuous review of relationships, in particular where clients are highly inefficient and often manually intensive. Custodians work with them to identify their resource consumption in the local markets with a view of passing on that cost whilst being as innovative as possible in the solutioning to the problems", he says.

"If a client is non-STP or highly intensive from a logistics or systems perspective, custodians are going to start passing on that cost, which will become even more expensive for smaller players"

Rob Scott, Commerzbank

With competitive pressure forcing custodians to assess the cost of service provision, repricing of business is a logical response – but given the cost compression on the client (think fee compression for the buy side or cost pressure within the sell side) is that viable as a response? And if the supply chain of custodial services does reprice itself, does this open up opportunities for new entrants to target parts of the business model?

The Emergence of Tokenisation

Custodians have historically safeguarded traditional financial assets but in the future this function will also be needed for digital assets or security tokens – digital securities recorded on a blockchain and which are issued in full compliance with securities regulations. As interest within digital assets becomes increasingly mainstream, institutional investors will also become increasingly interested in how to custody and service these assets. Whilst traditional bricks and mortar custody has had relatively high barriers to entry, the emergence of this new asset class creates opportunities for new entrants. But as Scott says, there is a clear need to differentiate between crypto assets (such as bitcoin) and tokenised assets. In particular as it pertains to the financial crime agenda of regulators.

"With crypto assets, the owner is invisible and the basis of the underlying security often questionable", he adds. "Who knows what or who sits behind these? As a result, mainstream Custodial services have been slow to evolve, as proving you are in total control of the financial crime aspects are challenging. Instead you begin to observe unregulated entities moving into this environment.

Scott however does believe there is a place for tokenised assets.

"At the end of the day, once you've solved being able to provide 'tokenisation of cash', which is still linked to an underlying USD or EUR or other currency deposit, and are able to mobilise both the 'tokenised cash' and securities across the globe, there a certainly a number of technologies that can make the post-trade process more efficient and lead to less friction and reduced overall cost within the industry", he says.

Commerzbank itself has been testing the use of securities tokens. In October 2019 Commerzbank and Deutsche Borse completed a delivery-versus-payment transaction using securities and cash tokens for settlement and collateral calls.

And whilst custodians continue to test the water with innovation around tokenised assets, the real challenge becomes how or if it becomes realistic to become all things to all people. And whilst they may face little threat from small, obscure companies providing storage capabilities for crypto-currencies, this increases as mainstream financial institutions enter the marketplace. The recent launch by Fidelity of its digital asset custody business is an example of an established institution entering the marketplace to provide competition within this space. So, understanding the position an organisation wants to take becomes increasingly important as service offerings move from concepts in innovation labs to mainstream products.

Increasing Costs of 'Pay to Play'

Given their critical role in the safe keeping of assets, custodians continue to invest significant amounts of money in 'lights on operations'. As the world becomes more digital, cyber security is an increasing area of focus and the downside of a cyber-security failure are significant. But just maintaining the cost of security is a heavy drain upon the resources of most custodians – and though this security is seen as a given by clients, it will detract from their ability to invest in other areas.

Ali Rutherford, managing director at Ascendant Strategy, concurs that custodians are investing heavily to protect themselves against cyber threats. He says: "I spoke to the chief information officer at a large US custodian and they are spending between $500m and $1bn a year on cyber security- though most of this is a lot of catch-up after quite a long period of stagnation."

John says investing in resilience is very important for custodians to protect both themselves and their customers. "As a trusted service provider, and in an environment of increasing expectations from regulators, resilience continues to be a focus.," he adds.

And whilst custodians must explore opportunities to enhance and expand their offering, this expansion must be tempered by the increasing costs of staying in business. As though maintaining compliance with regulation and provision of cyber security are seen by clients as a given, it isn't something that they will expect to pay more for.

The Power of Data

Digital transformation means increased demand for data services and analytics and the winners will be those custodians who provide the best smart data strategy and user experience to their clients. The emergence of FinTech innovation over the last 5 years has brought products to the market that can become transformational to a custodial service offering – but data accuracy and availability is significant blocker to their adoption.

O'Shea highlights "Asset managers are struggling to stave off the impacts of decreasing fees and the rise in passive investment, so are looking to their service providers for extra support. There is a huge amount of demand for data services, especially in areas such as environmental, social and governance (ESG) investment and alternative sources of information such as sentiment analytics. There is also demand for lower-cost middle and back office process support and regulatory compliance support"

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Virginie O'Shea, Aite Group

But this becomes challenging where inflexible legacy infrastructure that is supporting the custodial business models makes this hard to execute on. Being able to integrate this newer technology to deliver additional solutions to clients is challenging when much of the processing infrastructure and the underlying data is buried deep within old and complex architecture stacks.

Scott continues that large Custodians are much more open to partnerships and collaborations with Fintech. He says: "Holistically generated data, combining all the various client touchpoints with internal and external sources, leads to very meaningful insights, which simply cannot be seen looking at individual outputs. In turn this leads to a much deeper understanding and ultimately offers the ability of producing superior, tailored products and service for clients. All delivered in a more digitalised manner. These new products and services that will evolve will then begin to replace some of the more traditional revenue streams."

Matt Ruoss, CEO at Scorpeo, a provider of Corporate Actions Technology to custodians, also highlights a golden opportunity for custodians to use data more flexibly. "In order to do that, they are going to have to invest in emerging, transformational technology and deploy it alongside their existing infrastructure. Maximising the value of data and decision making will help custodians recoup revenue for their clients that is currently lost to inadequate processes and this will separate the best in breed," he says.

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Ruoss adds that custodians recognise the need to significantly improve the client service experience through using robotics, distributed ledger technologies and APIs that seamlessly plug into third-party technology.

"At the moment progress isn't matching ambition," he says. "However, this is a long-term transformational change and the burden of their legacy systems doesn't help a speedy turnaround."

Ruoss continues that custodians must monetise their position in the value chain by responding to client demands and providing complete solutions.

"A lot of securities services providers are thinking about revenues they can generate from new areas, but clients also want them to be more efficient with their existing processes, he says. "But they have to do it within the regulatory environment that they operate in, and in their position as a trustee of assets."

Rutherford also stresses the importance of data as custodians sit on so much information about behaviours and market activity.

He says: "So the theme is value-add, including data-driven insights, to other processing services like collateral management and securities lending."

Custody in the 2020's

The inherent challenge for the industry is understanding where to play, where to partner and where to avoid. The fixed costs associated with provision of custody are significant and create high barriers to entry for new market entrants. Brand safety is also a significant influencer around decision making for choice of service provider and is not something that can be developed overnight. In an environment where clients are looking for greater efficiency and are hungry for innovation, this creates both an opportunity and a challenge for the industry.

Ruoss echoes this point and says custodians need to be able to provide unique solutions to each client and significantly improve their service experience.

Even with the tendency to retain legacy infrastructure, custodians realize the importance of adopting automation and AI to reduce manual work" he added. "Successful adoption will require a shift in mindsets. Traditionally, banks have been hesitant to work with third-parties, but it's things like the use of APIs between new providers and legacy systems that will really help custodians break through."

John also stated that clients increasingly want to be able to access services via APIs. For example, in 2016 BNY Mellon launched Nexen, a user interface that uses APIs. John says: "Many of our clients use more than one of our services, Nexen is the way they can access all those services through a single gateway and make their lives easier."

But this challenge of where to play and how to monetise investments is key to the custodian value proposition going forward. The traditional approach of only developing products that clients will be charged directly for ultimately becomes too simplistic, so success requires a different approach to understanding how value can be extracted from the business model.

This increasingly looks like for most, developing partnership models with others to enable each organisation to really focus upon their core competence and how this can add value through the supply chain. The custodian provides a critical role in this chain but this doesn't mean that they are best placed to develop service offerings to provide value to their clients.

Seaberg highlights that vendors are keen to create managed service models to allow custodians to focus on their core business, rather than maintaining their infrastructure, but the buy-side is hesitant on using utilities.

"The whole managed service concept in this space could reduce the industry's overall cost," he adds. "They are hesitant on the buy side to spend a lot of time talking about utilities, because it's just not as advanced as on the sell side."

He gives the example of AcadiaSoft, which in September announced an initiative with BNY Mellon to allow buy-side market participants to manage margin calls, calculations, reconciliations and instruct the movement of collateral through a single interface.

Rutherford continues that in order to provide more flexibility and reduce cost, custodians should recognise that standardisation of services makes life easier for consumers, especially if clients can then integrate data into a consolidated view without having to build a bespoke interface for each of their custodians. They can also encourage innovation by collaborating with fintech start-ups.

"Rather than a custodian providing all your services where you get what they give you, they should provide more of a componentised approach where you select what you want from them from a menu" says Rutherford. "There is definitely a realisation from custodians that they need to support more of an ecosystem approach."

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Alastair Rutherford, Ascendant Strategy

By focusing upon the renovation work internally to enable access to newer, emerging technologies custodians are then able to leverage their unique role within the value chain to deliver additional, enhanced services to clients. And this can also be a key driver for their own efficiency agendas by removing pressure upon their own internal cost transformation programmes. As O'Shea comments "the industry obsession with total cost of ownership (TCO) continues – so operations tend to be measured on FTE replacement and cost savings with regard to reduction in vendor licenses or systems."

This 'obsession' distracts from efforts to truly understand the value associated with innovation and how these can be impactful to the end to end business model. By way of example, rather than focusing on the simplistic return on investment measures such as reduction in people it should look instead at work drivers. If a client can access their data through an API and benefit from smart insights into key exception causes, this ultimately is going to enable them to streamline process efficiency. And make them less likely to contact their custodian to understand why a process has failed.

Ultimately, the demand for innovative services (and the opportunity it creates) upon custodians will continue at pace as we head into the new decade. In the short term, the likelihood of widescale disruption of the core business of custodians is low but renovation of their legacy systems and processes is a critical requirement to building the custody service of the future. And central to this renovation is the role of data – both accessibility to and standardisation of – within this business model. This allows access to an eco-system of partners to provide innovation, allowing integration of Fintech-led solutions (such as digital asset servicing) that can be bundled under the traditional custodian brand. Ultimately, combining a partnership of safety and security of assets with cutting edge innovation to deliver an enhanced value proposition to clients. But being clear on what competencies the custodian brings and those that the partner provide is fundamental to successful delivery of this enhanced service model.

As Ruoss says: "If you're a builder, you won't tar your roof, you'll get a roofer to do it because you know they have the expertise to do it better and faster. So bring in the experts help, such as third parties and partner with them."

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