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The changing role of custodian banks

The world of the depositary bank is changing due to increased regulation

There has been much public debate and comment around initiatives aimed at reforming the European internal market and beyond it the global arrangements in the wake of the financial crisis. In general such initiatives are centred around two pillars – the drive towards greater investor protection and the measures aimed at identifying and mitigating systemic risk. One of the key areas where legislation seeks either to change or to clarify and harmonise existing practices is within the realm of the Depositary Bank and its close cousin the Custodian.

The principal instruments instituting these changes include:

- AIFMD (Alternative Investment Fund Managers Directive) and UCITS V (fifth release of the Undertakings for Collective Investment in Transferable Securities Directive)
- EMIR (European Market Infrastructure Regulation) and relevant clauses of its transatlantic cousin Dodd-Frank, both seeking to bring transparency and greater security to the world of Over the Counter (OTC) Derivatives
- Other longer term infrastructure projects such as Target 2 Securities (T2S).

To translate this intent into practical actions, these pieces of legislation are supplemented by guidance and direction issued by relevant authorities and bodies such as:

- ESMA (the relatively newly created European Securities and Markets Authority),
- IOSCO (International Organisation of Securities Commissions)
- US regulatory authorities operating under the general principles of the Dodd-Frank Act.

Such an ambitious legislative agenda will inevitably result in change, but in seeking to understand the dimensions of this change, and how each legislative package interacts, a brief look back as to how the current situation has arisen is a useful exercise.

A brief history

Clearly over the last two or three decades the industry has changed. To evaluate how far the current moves genuinely change the position, and to what extent instead they are a useful and necessary redefinition of existing principles and functions, understanding how the current situation has arisen is enlightening. To try to determine to what extent the stated goals of transparency, increased investor protection and the reduction in systemic risk may be met and at what cost will largely depend on how change is implemented.

The first truly international funds were created under the aegis of the initial UCITS Directive of 1985. This had the relatively modest ambition to create a basic internal market for investment funds either as investment or savings vehicles, giving European investors increased product choice. Even then national differences, and even difficulties in translating concepts as well as words, led to certain divergences in view and in approach.

In seeking to translate the European concept of the Depositary or “Depositaire” into English, the first imprecision occurred as the term Custodian presented itself as the closest equivalent. However the Depositary already had a connotation of greater responsibility than the notion of a Custodian. The former not only oversaw and assured the safe keeping of assets on behalf of the fund, assured the appropriate collection and application of income, settled transactions and carried out a wide range of ancillary administrative tasks for the fund, but also had a certain accepted if only partially defined role in the general governance of an investment fund, extending specifically to compliance functions in some instances, and de facto quite often to wider issues, through representatives of the Depositary also playing a significant role on fund boards, and being at the heart of the general conduct of the fund in practical and ethical, as well as operational, terms. In the Anglo-Saxon world there was a marked separation between these safe-keeping and operational aspects - the purely custody functions - and the oversight and governance aspects which more generally were concentrated – as they remain today – in the hands of the Trustee.

As the market developed and innovation brought an increasing choice of asset management expertise and asset classes to a wider spectrum of investors, both within Europe and beyond, this fundamental difference became even more blurred.

In short, over time there has been organic evolution, with cost imperatives driving operational efficiency, and asset diversification placing ever increasing demands on the “nominal” Depositary. If this workable but if sometimes uncomfortable alliance worked reasonably enough into a new millennium without any formal modification or legislative redefinition of the role, the flurry of activity that started with UCITS III, the growth of alternative funds and the progressive dismantling of exchange and fiscal barriers to investment in countries and asset classes globally posed new challenges. This was accompanied by unprecedented growth in synthetic assets and instruments such as OTC derivatives which put increasing strains on the lack of definition as to what effectively were the essential differences between a Depositary and a Custodian, if any, and where the non-Custodial role of the Depositary started and finished. If these questions might appear academic at the level of the Depositary itself, and in point of fact they were far from academic, the issues crystallised readily enough around the function of the correspondent or sub-custodian once Prime Brokers and “frontier” markets arrived, each in their own context.

Thus, a fund, albeit alternative, might hold all manner of securities, cash, loans and other assets and liabilities with one and the same broker – the “Prime Broker”, effectively internally funding a sophisticated trading operation on its behalf. This was not a context that had been envisaged in the legal framework surrounding custody and especially notions of Depositary liability. Nor was there a ready definition of where Prime Broker should fit within the accepted structures of Fund, Manager and Depositary. For want of a better solution, where the relevant Fund law required a Depositary and where the economic structure required a Prime Broker, the practice rapidly developed to require the Depositary to appoint the Prime Broker as a de facto sub-custodian. In practice quite often the Depositary was presented by the Fund manager with a “*fait accompli*”.

For “frontier” markets the problem was quite simply that legislation had never been formulated with the idea that a fund might wish to invest in markets where even finding a satisfactory sub-custodian could prove problematic, where the institutions and processes in a market may prove subject to corruption, manipulation, uncertainty and unrest, and still offer investment opportunities sufficient to attract managers and investors.

Ironically however it was not via an emerging or frontier market that the impetus for Depositary clarification was to come, but from the successive failure of a Prime Broker – Lehman Brothers – and a fraud – Madoff. As the survivors picked through the rubble, looking for recourse, the unresolved questions of liability in such cases came to the fore.

In a landmark case in France, Hedge Funds turned to the Depositary for restitution of the assets that the Depositary, at the instruction of the Fund and its Managers, had caused to be placed with a Prime Broker – Lehman Brothers, selected and chosen by those same managers, but contractually appointed as a correspondent or sub-custodian by the Depositary. In the case of Madoff, appointed also as a sub-custodian by certain funds, the assets were purely and simply lost through fraudulent activity.

The question was clearly posed – what exactly should be the Depositary’s liabilities and responsibilities vis-à-vis a fund?

What are the key changes?

Key legislative changes for the Depositary sector

Key clarifications are at last enshrined in legislation as to what the liabilities of a Depositary are for assets entrusted to it for safe keeping, its liabilities for other assets that cannot be kept in safe keeping, its responsibilities with regards to oversight and supervision of the fund, and any limitations thereto. Clarification is even given on what entities are eligible to act as Depositaries.

AIFMD will be the first new regulation to take effect but the guiding principles it embraces equally inspire UCITS V. It sets the scene for funds destined for professional investors, but will cover de facto those non-UCITS funds that are in practice sold to retail investors as well. UCITS V will use tighter versions of these same standards, since UCITS are still considered by most to be primarily destined for retail investors.

Liability

Broadly speaking the Depositary is liable for the timely restitution of any assets that are held in safe-keeping and that are lost. In general any assets that may be held in safe keeping must be held in safe-keeping, and in all events attract the same level of liability for the Depositary in the event of loss. Shares in investment funds may prove an exception to this rule, although on this point opinions still diverge.

There are a very limited number of situations in which this liability for the Depositary may be waived; the most notable is where the Depositary identifies a sub-custodian or correspondent ready to contractually assume the same degree of liability vis-à-vis the fund as the Depositary itself, or where despite all efforts a Depositary cannot identify a suitable correspondent or sub-custodian in a given market.

(In these circumstances the Depositary formally reports to this effect but is nevertheless instructed to open a correspondent arrangement by the duly authorised Manager. Relationships with Prime Brokers will generally not fall into this category, and interestingly the Depositary still has a specific obligation with regard to the selection and evaluation of a Prime Broker that could still render it partly liable even if a Prime Broker were to assume full responsibility and liability vis-à-vis a Fund).

Oversight

A new concept for the Depositary is one of effective oversight of the funds for which it has been appointed, a significant extension of the previous duties with regard to contractual funds. This not only involves the implementation of a sophisticated control framework to try to ensure that the Depositary will not be exposed to a loss or misconduct, but makes the Depositary an integral part of fund governance. Information flows must be set up so that the Depositary can conduct ex-post controls and verifications on aspects such as the transfer agency functions, valuation of shares, investment compliance, timely settlement of transactions and income calculation.

Depositary location and structure

Whereas previously fund managers in the alternative space could choose fairly freely the location of the depositary for their funds, new EU rules limit this freedom, ensuring the use of EU rules as far as possible.

This, along with direct responsibility for sub-custodians, will cause Depositaries to rethink their business model from a geographical approach as well as assessing the sub-custody network. This may involve requesting legal opinions on relevant jurisdictions, conducting custody risk assessments and monitoring the evolution of the cooperation agreements being concluded by ESMA with its peers in non-EU countries.

Cash monitoring

The Depositary under the AIFMD is faced with new rules on its task of cash flow monitoring. This means that the Depositary must be able to immediately identify all major cash flows and be able to reconcile them with their purpose. This includes cash flows to and from third party providers such as Prime Brokers. Where discrepancies are identified the Depositary is duty bound to ensure appropriate remedial action is implemented. These measures are designed to contain the potential for fraudulent use of cash belonging to the fund and thus increase the level of protection for the investor. Most or all of these provisions for AIFMD will also appear in UCITS V save the potential delegation and derogation of responsibility. Under UCITS V the Depositary is likely to be liable – full stop.

If this is the dimension of the change, what are the likely practical impacts for the industry?

Size

Will the implicit direct and indirect costs of meeting these obligations lead to a concentration of the market around a reduced number of larger actors? When one digs down a little into operating practices, and consults with end users, asset managers and others who have recourse to the services of Depositaries and Custodians, one finds a mixed picture.

“Big” certainly gets a Depositary / Custodian onto the RFP lists, but it is questionable if size is necessarily synonymous with the most appropriate. In Luxembourg, however, which is the biggest fund domicile within the EU, 75% of the assets under management are held by the 10 biggest custodians. It is anticipated that this concentration will continue to increase in the current regulatory context as other entities reconsider their position in the face of rising costs.

This may be seen as potentially adding a new systemic risk, rather than alleviating one.

Pricing

Depositaries and Custodians have sought to alert clients and public alike to the cost impacts of the changing regulation, however this alert has rarely included quantifiable evidence.

Since custody is a volume-driven business, profitability lies in the ability to attract and to take on significant volumes of business, and incremental volume driven fees, at very low margins, with a minimal increase in overhead and expense. Profitability for a Depositary, by contrast, relies on accurately pricing risk based services at a level that reflects the incremental increase in overhead associated with volume increase.

Clearly there is scope for convergence between these two apparently different objectives; to the extent that the risk based, value added services can be increasingly automated and industrialised, the Depositary model converges on the Custody model.

It remains a truism that a “Depositary” needs to offer Custodial services, whereas a Custodian, an efficient and profitable Global Custodian, does not need to offer Depositary services. It should also be noted that “oversight” duties have traditionally been the element of Depositary fees subject to VAT. An increase in oversight fees in line with activity implies a not insignificant increase in VAT.

The role of insurance for the depositary sector

The role, either current or potential, of insurance is to mitigate the Depositary liability. It has been said that the amounts involved are simply too huge to be validly insured. However, Custodians already carry liability insurance. Furthermore, the risks that existing insurance arrangements seek to insure are potentially less manageable than pure duties of safe keeping and the statistically low probable risk of actual loss; they generally cater for protecting Custodians against acts of incompetence, negligence and even criminal intent on the part of their employees, or others.

When one considers also the nature of any insurance activity, the paradigm is generally the same. The total value of all insured shipping tonnage far exceeds any capacity of the insurance market to pay for a massive concurrent spate of maritime catastrophes. In fact, it is only in realms of protracted conflict that insurance coverage can in general not be found at all. The secret is of course in using actuarial models to reflect the fact that such catastrophes are rarely concurrent. The same concept may well find its place in insuring Depositary liability.

New framework for actors

In the alternative funds sector, the AIFMD establishes two regimes: safekeeping and oversight, both of which impose rather onerous responsibilities on the Depositaries, requiring an increased control framework within them. We have identified the following as being the topics which will cause the greatest impact on Depositaries:

- Entry into the market of new non-credit institution Depositaries (albeit for a restricted fund segment),
- Enhanced and extended role of Depositary of Depositaries in the governance structure,
- Due diligence conducted by the AIFM on the Depositary (including evidence of AIFMD readiness),
- Definition of financial and non-financial assets that imply safe keeping or simply record keeping,
- The relationship the Depositary intends to have with the Prime broker and the model which will be adopted.

What is our vision for the future?

For funds, AIFMD and UCITS V create an environment wherein there is a triangular relationship between manager or management company, fund and Depositary. Within the Depositary there is again a triangular relationship involving Custody, Depositary and Fund.

As has been noted, a Depositary needs a Custodian but a Custodian does not necessarily need a Depositary – and a Fund needs both.

To what extent that need becomes a driver in pricing is a function of the buying power that the buyer can exert, other commercial relations and similar factors, and the degree of integration of the Depositary and Custodian network within a single organisation. The great and the good will in all probability see little change in price, the custodians' preference for custody activities over depositary ones will be reinforced, and the middle and lower tiers of fund will in all likelihood have to pay up to secure the services they need. For those forced to pay more, the more exotic their intent, the higher the probable price.

The areas that are likely to cause the greatest concern and that risk proving the weakest links and potential points of failure are where, somewhat akin to the past, parties are forced into roles that are not strictly speaking their area of expertise. A Prime Broker is not a sub-custodian, much less a Depositary. Prime Brokerage activities do not sit easily with the notion of custodial record keeping.

The interesting question is what comes next? Certainly there is now a degree of clarity, and there is nothing a priori that would prevent this model demonstrating an equal longevity to the previous one. Indeed it is continuity in most respects rather than a change in model.

However, there are indications on the horizon that this is unlikely to be the case. When putting in place the necessary modifications required by current regulatory change, the market in its broader sense would be well advised to keep in mind at least two things:

- Firstly, the ***Depositary passport*** will come; when, we do not yet know, but it is a logical continuation of existing cross border and passport arrangements. If it will prove any more revolutionary when it does emerge than it has to date for management companies remains a moot point. Efficient and effective business models will attract business irrespective of location and the best preparation for the passport when it does come is to ensure efficiency within that fund/depositary/custodian triangle that will stand the test of time.
- The second potential impact and source of further change is a little harder to factor in. Throughout the current reflection on Depositary liability and duties there has been a "leitmotif" that is only partially enunciated, but is nevertheless clear. This is the notion of finding an appropriate ***"guarantor" of last resort*** for the activities of a fund. In some jurisdictions this function has been previously fulfilled by the notion of the "promoter", in others to some extent by the Trustee. It is nevertheless a notion that is difficult to translate into the cross border environment.
  In looking at the various actors – the primary triangle as discussed previously – the choice of potential "guarantor" is both limited and redolent of unintended consequences.

This could even be extended: there may be a quid pro quo between Depositary liability and the maintenance of the current broad regime of eligible asset. There has certainly been some discussion around recompense for asset impairment or loss in value which would clearly be unhelpful in the extreme by dissociating the investor from all responsibility for investment decisions.

Today the Depositary already has a defined role in corporate governance. There is a real need to find ways to restore investor confidence in the fund product, not least because developed democracies need first-rate asset management and products if they are to deal with the time bomb of an aging population. The alternatives – bank offerings and insurance wrappers – often lag far behind in terms of absolute cost, transparency and appropriateness. It is interesting to note that in North America (the home of the uncomplicated Custody model) over 30% of all retirement savings go into funds, and that for all the public debate on the other side of the Atlantic, we have seen no trend towards savers turning their backs on such products.

Will that trend be replicated in Europe if the Depositary liability is further extended?

Please see our website for further information on the **EMEA Centre for Regulatory Strategy**.

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