The 9th Annual Report on CUSTODIAL SERVICES

After a poor performance in 2001, custodians worked hard to meet new client expectations and grow their businesses. Our special report on custodial services finds that creativity flourished in tough economic conditions. **By Anna Sharratt**

After another year in which equity markets continued to fall, one might think that it would be hard to find an optimistic custodian. Not so. Last year, despite taking a hit in traditional revenue lines, value-added services saw a lot of interest. Services such as transition management, securities lending, outsourcing and risk management all took centre stage as pension funds looked for ways to cut costs and manage their risks.

"On the value-added side, transition management, securities lending and outsourcing mitigated some of that loss or lower levels of revenue," says José Placido, senior vice-president of RBC Global Services in Toronto. "The market actually forces us to look at other areas we can be providing services to our clients."

One might say that the market situation, in certain lines of business, has actually led to profitability. The reason, say custodians, is that they spent much of 2002 continuing to take on more advisory roles to meet client demand. Adaptation paid off.

"I think the role of global custodians—even prior to last year—has been transformed," says Placido. "On the base line, you've got most of the key providers who have survived consolidation over the years. They have put a significant investment in technology and what we call the value-added spectrum of services."

The demands on custodians are certainly high. Clients are looking for services that can reduce their fees and improve their bottom lines. Many are struggling to stay profitable. Clients themselves have grown in sophistication and complexity and now demand advice on diversification and risk management. And in the wake of Sept. 11, the need for strategies on designing business contingency plans has grown.

"You're seeing greater use of derivatives, you're seeing greater use of front-end tools," says Placido. "We need to be there and to respond to the evolution of where the portfolio managers are going in terms of these markets."

TRANSITION MANAGEMENT

New to Canada, transition management is a service which has seen a lot of interest in the past year. The process in which the portfolio of a terminated manager is traded as efficiently and as quickly as possible and then passed to another manager, transition management is about keeping costs low and minimizing risk. For that reason, pension plans have turned to it.

"Transition management would never have been the mandate of the custodian in years past," says Tom MacMillan, president and chief executive officer of CIBC Mellon Global Securities Services Co. in Toronto. "When a plan sponsor changes a manager, that action has the potential to be a very inefficient exercise."

MacMillan says the process requires that trades are carried out avoiding discounted prices, foreign exchange handled efficiently and the process timed to occur when markets will aid the transactions.

He, like many custodians, reports a strong demand for transition management due to the growth in portfolio size and complexity. "There is [a big demand]. As the complexity of the investment activity increases, so do the demands on the custodians to provide products like this."

Another service which has seen continued popularity is securities lending. MacMillan says that lower market returns have led plan sponsors to continue to view it as a way of boosting returns on equity. "Our number of clients is actually up. I think as markets pick up, you'll probably see that pick up as well."

David Toyne, managing director with State Street Trust Company Canada in Toronto, agrees securities lending, although negatively impacted by the tough market conditions through fewer arbitrage opportunities, is being requested by more clients. "My sense is that securities lending continues to be more important for our clients." He hopes that State Street's 2002 acquisition of Deutsche Bank will be beneficial for the service.

"One advantage is that there [will be] increased liquidity when [Deutsche Bank's] securities operation joins with ours—for access to increased securities lending assets."

2002: THE FIGURES

That kind of optimism paid off for State Street in 2002. The custodian had a 35% increase in pension assets under custody and watched its assets grow to $166 billion in 2002 from $123 billion as of Sept. 30, 2001. "We had a spectacular year on the pension side," says Toyne.

Smaller player, Northern Trust Company Canada also posted an increase over its total of $12.3 billion in 2001. In 2002, it saw a $7.1 billion or 57.7% increase, with pension assets under custody of $19.4 billion.

But not all the custodians were so lucky. RBC saw its pension assets under custody slightly decline, falling 2.3% to $261 billion in 2002 from $267 billion in 2001. CIBC Mellon also posted a decrease in assets, dropping from $138.2 billion in 2001 to $126.4 billion in 2002—an 8.5% decrease. And Desjardins Trust had its assets decline by $7.4 billion to $82.2 billion in 2002 (see "Pension assets under custody," right).

Overall, the industry's assets grew last year, with pension assets under custody totalling $747.2 billion. This was a marked improvement over last year's asset total which was, as reported in BENEFITS CANADA's *8th Annual Report on Custodial Services,* $646.7 billion, as of Sept. 30, 2001.

On the mutual fund side, the industry's performance also saw improvement. Mutual/pooled fund assets under custody grew 15% or $78.3 billion to $598.3 billion (see "Mutual/pooled fund assets under custody," right). State Street and Northern Trust had the biggest declines. State Street's mutual/pooled fund assets under custody dropped $13 billion or 10.6% to $110 billion, due to the sale of Merrill Lynch Canada Inc. to CIBC. Northern Trust lost a $7 billion client in 2002, dropping its asset total to $19.3 million from $7.7 billion in 2001. In fifth place last year, it dropped out of the top five in 2002.

The rest of the top five custodians all had increases over last year. RBC took the lead, with $272 billion in mutual/pooled fund assets under custody—a jump of $29 billion or 11.9% over 2001. CIBC Mellon, in second place, had a mutual fund total of $184.9 billion—an increase of $49.2 billion over last year's figures. JPMorgan Investor Services took fourth spot, with assets totalling $20.9 billion—a far cry from its 2001 asset total of $1.8 billion. As for National Bank Trust, the custodian's total was $5.6 billion.

Pension assets under custody

Pension assets under custody grew to $747.2 billion last year. While RBC held onto the top spot, State Street was the big winner with a 35% increase in assets to $166 billion. It moved into second place from third place last year.

Ranking	Company	Pension assets under custody as of Sept. 30, 2002 ($billions)*
1.	RBC Global Services	$261.0
2.	State Street Trust Company Canada	$166.0
3.	CIBC Mellon Global Securities Services Co.	$126.4
4.	Desjardins Trust	$82.2
5.	Northern Trust Company Canada	$19.4

Source: BENEFITS CANADA's 9th Annual Report on Custodial Services.

* Includes assets of pensions, group RRSPs and other capital accumulation plans of Canadian operations' clients invested in Canada, the U.S. and non-North American markets.

Mutual/pooled fund assets under custody

Mutual and pooled fund assets under custody grew 15% or $78.3 billion to $598.3 billion. Northern Trust posted a decline in assets of 99.7% to $19.3 million and fell out of the top five.

Ranking	Company	Mutual/pooled fund assets under custody as of Sept. 30, 2002 ($billions)*
1.	RBC Global Services	$272.0
2.	CIBC Mellon Global Securities Services Co.	$184.9
3.	State Street Trust Company Canada	$110.0
4.	JPMorgan Investor Services	$20.9
5.	National Bank Trust	$5.6

Source: BENEFITS CANADA's 9th Annual Report on Custodial Services.

*Includes mutual/pooled fund assets of Canadian operations' clients invested in Canada, the U.S. and non-North American markets.

Custody by numbers

Total number of clients reported by this year's survey respondents:	**5,396**
Of those, the number of pension trust clients:	**2,541**
Total number of account supervisors in the custody industry, as reported by survey respondents:	**56**

T+1

While the industry focused its efforts on achieving profitability, other projects took a backseat. The T+1 campaign, which had been in full swing throughout 2001, lost momentum and was deferred to 2005. While the Canadian Capital Markets Association (CCMA) is still setting timelines and aims to meet the new deadline, the process has slowed considerably.

MacMillan, who heads the CCMA, explains that there were several reasons T+1 was temporarily shelved. "I think there are a number of reasons that happened. One of which is the market. I think there are less dollars available for major projects. And there are other priorities. Post-Sept. 11, there is enormous concern around business recovery and regulatory pressure. In any company there are only so many hours in the day to do these things."

Barbara Amsden, CCMA treasurer in Toronto, says that another reason the T+1 plan has been extended is that the U.S. Securities Industry Association (SIA) decided to halt the T+1 process in May 2002. It had decided to focus its efforts on straight-through processing (STP) instead of moving towards a T+1 deadline it felt it couldn't meet. Canada followed suit.

"We also stepped back and said, 'We'll watch what it (the U.S.) is doing and if we need to revisit it as well,'" says Amsden. In July, the decision was made in Canada to move away from T+1 and focus on achieving STP in the next two years.

STP has now become the industry's focal point. A way of fully automating financial processes so that all service providers can more efficiently and quickly receive data, STP has been embraced by most of the larger custodians.

"It makes good business sense to move this way, says MacMillan. "And I don't think there's anybody in the industry who doesn't think this way."

Placido agrees. "I think the business case is self-evident when you look at some of the inefficiencies of failed trades and some other things that are happening in the securities industry."

But the challenge will be to keep the momentum going. The dissolution of the Global Straight Through Processing Association due to lack of profitability late last year means the STP movement will need a push and industry backing.

Although Amsden says that complying with the new deadline will be a challenge, the top custodians have pledged to move it forward. Says MacMillan, "the only way this is going to happen is a complete industry effort."

EMERGING TRENDS

One other industry effort which is paying off is outsourcing—the farming out of various operations to custodians—which saw more clients last year. Known for reducing costs, outsourcing has taken off on the mutual fund side. On the pension side, however, there is still caution.

RBC's Placido says that mutual fund and asset management industry clients are currently outsourcing back office functionalities. Pension clients, on the other hand, are largely outsourcing performance analytics, compliance monitoring and data warehousing. But they're slowly moving in the back-office direction.

"The interest in outsourcing has increased tremendously in light of some of the discussions we're having and other global custodians are having in this country."

Two areas which are also being outsourced more often are advisory services such as regulatory compliance, risk management and corporate governance. As well, the aftermath of Sept. 11 has led to greater awareness of business risk associated with disaster, and clients have begun to seek advice on how to make their businesses safer.

"The whole issue of asset liability and liability management as well as the ability to qualify and quantify risk is very much on the minds of chief investment officers of pension funds," says Toyne. "From our perspective, having risk management capabilities is a very important part of our tool kit."

FUTURE OUTLOOK

Custodians are looking beyond Canada to grow their businesses. State Street took a big step last year with the acquisition of Deutsche Bank. With consolidation narrowing the playing field at home, custodians hope to increase their presence.

As for clients, they will have to look outside Canada to diversify portfolios, say custodians. "From a foreign client perspective, Canada is an interesting place to invest," says Placido. "But at the end of the day, from a diversification standpoint, our clients are going to have to look outside of Canada to give them that element of diversification."

Clients will also look to custodians to meet challenges brought on by consolidation, the poor performance of capital markets and the increased need for automation. Custodians will have to be the advisors, offering solutions, developing new services to minimize costs and highlighting the industry's need for straight-through processing. Managing transition will truly become the custodial focus. **BC**