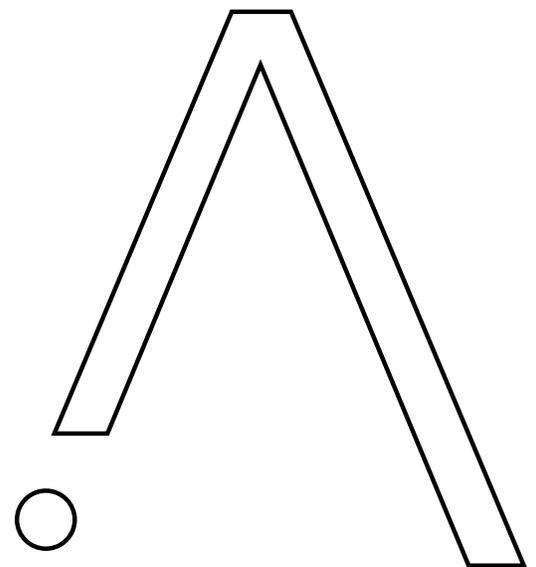


# EVALUATING CUSTODIAL BANKS AS ASSET SERVICERS: WHY IT MATTERS

Institutional investors are navigating a challenging financial landscape – persistent market volatility, continued regulatory complexity, rapid technological advancements and evolving investment strategies. In an effort to generate meaningful returns amidst the evolving landscape, investors are diversifying their portfolios with more complex investment strategies, including increasing allocations to more esoteric assets. They need ready access to comprehensive information about their investments and the markets in which they invest, as well as advanced technology to optimize decision-making.

As the rate of change increases in the investment arena and the regulatory environment continues to tighten, the value proposition of the global custodian – risk management, operational efficiency, strong span of controls, access to data and technology – is more relevant today than ever. Custodian banks are independent entities, operating separately from their clients’ asset managers, asset owners and other service providers to maintain objectivity and avoid conflicts of interest, providing an extra layer of security and integrity. They are, first and foremost, guardians of their clients’ assets, and have also embraced innovation, automation and technological advancements. Add to this a greater focus on supporting front-office decision-making, custodians are now able to provide a broader range of services and support to institutional investors. In this rapidly evolving environment, it is important for institutions such as foundations and endowments, healthcare institutions, insurance firms, international organizations, public and corporate pension funds and investment vehicles to understand how the right custodian can serve as a critical partner.

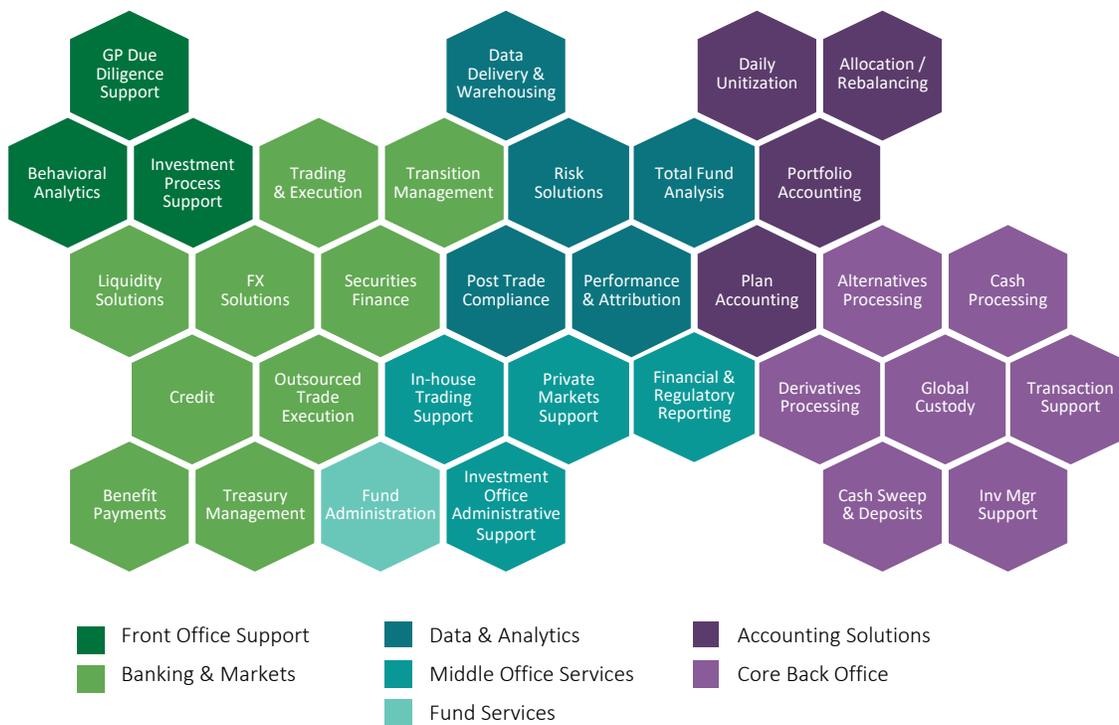


**GLOBAL CUSTODIAN IS A STRATEGIC PROVIDER**

Whether servicing new asset types, operationally supporting investment growth in emerging or frontier markets, or processing complex transactions, global custodians must be flexible and adaptable to meet client needs and remain competitive. The increase in allocations to alternative investments, such as private equity, also introduces additional nuances and challenges when it comes to analyzing and reporting performance, exposure, risk and liquidity.

Service providers like global custodians utilize advanced systems and technologies to enable more timely delivery of performance data, seamlessly adapting to market and regulatory demands as requirements continue to evolve. Solutions like these provide strategic benefits and position clients to succeed. And by aligning with a strategic provider that is attuned to its client’s needs, the institutional investor is better able to focus on executing its business growth and overall mission.

**Comprehensive Solution Suite, Organized and Tailored to Asset Owners**



**KEY THEMES DRIVING A REVIEW OF GLOBAL CUSTODIANS**

There are three key themes to be mindful of when assessing, evaluating and quantifying the differences across global custodians: asset safety and risk management; operational excellence; and value for money.

**Asset safety and risk management**

- Promoting transparency as a core tenet between client and custodian so clients understand the state of their assets at all times and are aware of potential risks.
- Ensuring robust measures are in place to protect client assets from fraud, with a focus on integrity and stable operations.

## EVALUATING CUSTODIAL BANKS AS ASSET SERVICERS: WHY IT MATTERS?

### Operational excellence

- Flexibility of systems to implement enhancements when opportunities to increase efficiency are available in all functions from core custody asset servicing to reporting and analysis.
- Utilizing advanced technology and automation to consistently drive operational efficiency and adapt to changing client needs.

### Value for money

- Leveraging the custodian’s investment in people and technology, allowing clients to focus on their core mission.
- Demonstrating cost-efficiency through streamlined processes and economies of scale.

## FIVE KEY FACTORS TO EVALUATING A STRATEGIC PROVIDER

An institutional investor should closely examine five main categories, which offer insight into a provider’s entire organization, when evaluating differences among global asset providers:

1. financial strength
2. organizational commitment
3. operational strength and resiliency
4. investment in and deployment of technology (including cybersecurity oversight)
5. quality and depth of products and services

For a global custodian to succeed on behalf of its clients, each of these five categories must operate at its fullest potential. Collectively, they form a framework to determine the best strategic asset servicing provider suited for the institutional investor. For each category, the institutional investor should ask how this affects asset safety, risk minimization, operational excellence and value for money.

### Five Characteristics Investors Should Review in Evaluating a Custodian Bank

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## 1. Financial Strength

**Why is it important?** Financial strength is necessary for continual reinvestment in the business for the client's benefit. Significant capital resources are often needed to respond to changes in:

- Capital markets
- Asset types
- Private investment transparency needs
- Technological advancements
- Global security settlement and depository regimes
- Investment strategies
- Financial disclosure requirements
- Tax rules
- Accounting standards
- Government and financial market regulatory frameworks

In addition, it's important to assess how the custodian allocates capital across its internal systems versus investing in new technologies and product capabilities that deliver solutions directly to clients.

**What to measure:**

- Asset accumulation (organic business growth versus acquisitions)
- Percentage of total revenues derived from core custody and related services
- Investment in staff
- Credit ratings and ratings outlook
- Capital ratios
- Quality of balance sheet

## 2. Organizational Commitment

**Why is it important?** Commitment to the business ensures alignment of resources to meet client needs. There are multiple factors to consider when assessing organizational commitment, including client service and core custody/asset services.

### CLIENT SERVICE

Client servicing is one of the most-important differentiators in the asset servicing business. Custodians offer a wide variety of products, services, capabilities and technologies. With open communication, ongoing service monitoring and a strong relationship review process in place, clients have greater transparency into their service provider's operations.

**What to measure:**

- Expertise in client specific market segments
- Experience with similar clients
- Dedicated relationship manager and support team
- Service-level commitments and key performance indicators
- Thought leadership and best practices
- Review meetings with clients
- Central tracking for queries

### CORE CUSTODY/ASSET SERVICES

Core custody consists of such services as post-execution trade processing and settlements, income collections, asset pricing, proxy voting, corporate actions processing and tax reclaims. A custodian's core operating system and direct links to sub-custodians, counterparties, investment managers, brokers and depositories achieve optimal straight-through-processing rates. This mitigates the risk for potential errors.

### What to measure:

- Securities movement and control metrics
- Cash and position reconciliation by sub-custodians with the local market and global custodian to sub-custodian
- Single data repository
- Settlements rates, fail rates and system reporting time (i.e., intraday versus overnight)
- Number of contractual markets
- Corporate actions (within 24-hour market announcement); income; class actions; historical class actions; proxy voting capabilities; and reporting
- Tax reclaims – transparency, reporting, education and global documentation

### 3. Operational Strength and Resiliency

**Why is it important?** Operational strength encompasses a custodian's global custody and sub-custody networks, along with a strong business continuity and disaster recovery plan. It underlies the custodian bank's ability to support global asset classes, global time zones and frontier markets, to name a few.

#### GLOBAL REACH AND SUB CUSTODY NETWORK

A well-developed sub-custodian network is vital to the custodian's ability to facilitate safekeeping, transaction processing, and asset pricing worldwide.

### What to measure:

- Global custody platform is multicurrency
- Number of global markets offered
- Restricted currencies supported
- Onsite monitoring of all networks during global market hours
- Regular operational and credit risk reviews of sub-custodian relationships
- Contingency plans in the event of sub-custodian insolvency
- SSAE 16 third-party auditor report

#### BUSINESS CONTINUITY AND DISASTER RECOVERY

The custodian must maintain proper controls and procedures in the event of an unexpected disruption to business as usual.

### What to measure:

- Disaster recovery plans
- Offsite locations
- Information security controls framework, including cyber security
- Back-up servers and frequency for refresh

### 4. Investment in Technology

**Why is it important?** Technology drives all aspects of the business and investment in technology is essential for custodians to stay ahead and offer more efficient services to clients in this rapidly evolving financial landscape.

### TECHNOLOGY AND AUTOMATION

For a custodian to compete as a market leader, it must have an operating platform that seamlessly connects with the marketplace and is integrated between custody, accounting and other value add systems. With the adoption of application programming interfaces (APIs) and cloud-based solutions, custodians should be able to seamlessly interface with a wide variety of third-party software solutions, enabling more efficient operations and automated reporting capabilities that enhance transparency and real-time data access.

#### What to measure:

- Annual technology expenditure and projections
- System connectivity (custody, accounting, performance, etc.)
- Connections with the industry (i.e., SWIFT, depositories, etc.)
- Percentage of spend relative to business
- Frequency of data refresh to downstream systems
- Efficiency gains from API-driven automated reporting and data exchange

### 5. Quality of Products and Services

**Why is it important?** The quality of a custodian's products and services, listed below, is an important factor to consider because institutional investors are increasingly seeking ways to operate more efficiently and effectively. Innovative products help them address reporting challenges, business priorities and growth strategies.

#### CASH MANAGEMENT

Clients should assess the global custodian's ability to process cash transactions in an automated environment; credit and debit interest arrangements; alternatives for sweeps or short-term investment funds; and operations.

#### What to measure:

- Process to maintain and update authorized signors
- Pre-advice on cash and same-day valuations for client-directed cash
- Cash-pooling arrangements
- Credit/debit rates
- Timing for trades
- Investment vehicles, money market funds, variable net asset value funds
- Balance-sheet strength
- Markets offered
- Cash-forecasting reports and liquidity views

#### ACCOUNTING

The accounting engine is a key data source for asset valuation and performance measurement reports. The custody data and accounting data must be integrated and automated. Clients need transparency and oversight into books and records; therefore, data warehouse capabilities are critical. The custodian's ability to store and quickly report on items that could affect an account or fund is key (i.e., total exposure to a particular company).

#### What to measure:

- Intra-day, daily and monthly checklists, processes and procedures
- Intra-day profit and loss statements
- Accounting principles supported (IFRS, GAAP, GASB, etc.)

## EVALUATING CUSTODIAL BANKS AS ASSET SERVICERS: WHY IT MATTERS?

- Pricing vendors and hierarchies
- General ledger interface capabilities/trial balances
- Accounting deadline deliverables
- Regulatory and financial statement preparation support offering(s)
- Client-provided pricing capabilities

### PORTFOLIO ANALYTICS (PERFORMANCE, COMPLIANCE MONITORING, RISK)

Analytical reporting services have become increasingly important as clients are expected to do more with less. The portfolio analytics services that custodians offer directly increases the potential for operational capacity savings for a client's own internal operations.

#### What to measure:

- Performance, compliance and risk systems
- Fund look-through to underlying assets (public and private funds)
- Compliance offering/rule-breach notification
- Ex-post and ex-ante risk analysis
- Exposure by region, currency, sector, industry, investment strategy, etc.
- Alignment – across entire pool by limits, leverage fund, currency, credit risk limits, forward-looking risk
- Private equity commitment tracking
- Hedge fund liquidity tracking
- Strategy specific, bespoke tagging

### FOREIGN EXCHANGE

Custodians should provide negotiated spreads for trade-related foreign exchange; pre-determined spread arrangements for income and corporate action-related foreign exchange; time-stamped data; and reporting to provide the transparency clients need to properly monitor spot rates.

#### What to measure:

- Custodial counterparty risk
- Settlement performance
- Time-stamped reporting
- Flexible dealing times
- Commitment to foreign exchange spreads
- Net foreign exchange trade flows
- Experience in restricted currencies
- Online access for client reporting

### SECURITIES LENDING

Clients should review and measure a custodian's ability to offer securities lending that meets the needs of individual clients. Particularly important are the custodian's contractual commitments, algorithms for loan allocations, collateral reinvestment management, indemnification levels, revenue splits, performance and reporting abilities.

#### What to measure:

- Risk oversight and governance structure
- Collateral performance reporting
- Mark-to-market collateral

## EVALUATING CUSTODIAL BANKS AS ASSET SERVICERS: WHY IT MATTERS?

- Reporting (utilization percentage by asset class and market; spreads by asset class and market; counterparty exposure; non-cash and cash collateral reporting; breakdown of revenue between loans)
- Indemnification levels (important to note – indemnification levels are not tied to revenue splits)

## IMPORTANCE OF CUSTODY EVALUATION

Ultimately, institutional investors who are vetting potential service providers should give equal weight to each of the five performance evaluation categories. For a client to consider a custodian successful, all five categories should operate at their highest potential. Any underperformance in these categories has potentially negative consequences for the client, such as asset safety risk or adverse impacts to client operational efficiency. Similarly, insufficient monitoring and reporting can result in a lack of transparency and decrease investment performance. Altogether, underperformance in these factors can lower the custodian's "value for money" from the client's perspective.

## FINAL CONSIDERATIONS FOR SELECTING A CUSTODIAL BANK

Assessing custodial banks as strategic partners is a complex and multi-faceted process for institutional investors, particularly given the current financial landscape. When evaluating the differences between custodians, it's important to be mindful of asset safety and risk management, operational excellence and value for money. Additionally, closely examining the five critical categories will help institutional investors identify the right provider for their needs. Now more than ever, custodians can provide a wide range of services, technology and support to help investors in their quest for alpha. Making a thorough evaluation of these elements is essential when it comes to choosing a partner that aligns with their strategic objectives.

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