Adapting custody services for modern asset managers and asset owners

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Abstract

Custodian banks have long been the unsung supporters of the investment industry, ensuring the smooth operation of transactions, servicing large institutions and infrastructure to support significant amounts of money management. As modern asset managers and asset owners continue to grow, however, they will demand more from their custodian-partners. The demand for services will come from more sophisticated, technology-reliant functions, and as such, the role of custodians will undergo a profound transformation. What has helped custodians be successful so far — reliance on people and process to deliver services — will not continue to help them in the future. This paper explores considerations for custodians and the adaptations required *in their service models to meet contemporary challenges. We conclude that a fundamental shift is required away from traditional mindsets to ensure custodians remain central to supporting the needs of asset managers and asset owners.*

Keywords: custodian, investment data, operating model transformation, data-as-a-service

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INTRODUCTION

The dynamic field of asset management is witnessing a pivotal transformation. As asset managers and asset owners seek to adopt increasingly sophisticated and flexible investment strategies, the imperative for custodian banks to redefine their traditional roles has never been more critical. Historically, these banks have formed the conservative backbone of the investment industry, but now they are uniquely positioned to offer pivotal value-added services that can significantly enhance the strategic capabilities of asset managers and asset owners alike.

BACKGROUND

Custodian banks have traditionally been the bedrock of the investment industry, safeguarding assets and overseeing smooth portfolio operations. Over the decades, their role has expanded from safekeeping to encompassing comprehensive administration services, thus positioning them as natural and capable providers of fund reporting and accounting services to investment organisations (see Phase I, Figure 1). This role expansion is a testament to the settled debate favouring the outsourcing of these functions to custodians, who are recognised for their robust scale, global support models and infrastructural capabilities.

Increasingly, custodians have been moving further up the value chain, aiming to assert their role in supporting middle office, over-the-counter (OTC) derivatives and client and performance reporting during outsourcing Phase II and with trade execution capabilities in Phase III.[2] This strategic move is supported by their unique position as the primary holder of data and as a central connector within the financial markets data ecosystem.

Theoretically, this setup is poised to deliver enhanced services at lower costs, thereby enabling investment managers to focus predominantly on refining and implementing investment strategies. Success of both these phases has been delivered largely by business process outsourcing. The next phase of this outsourcing pathway (Phase

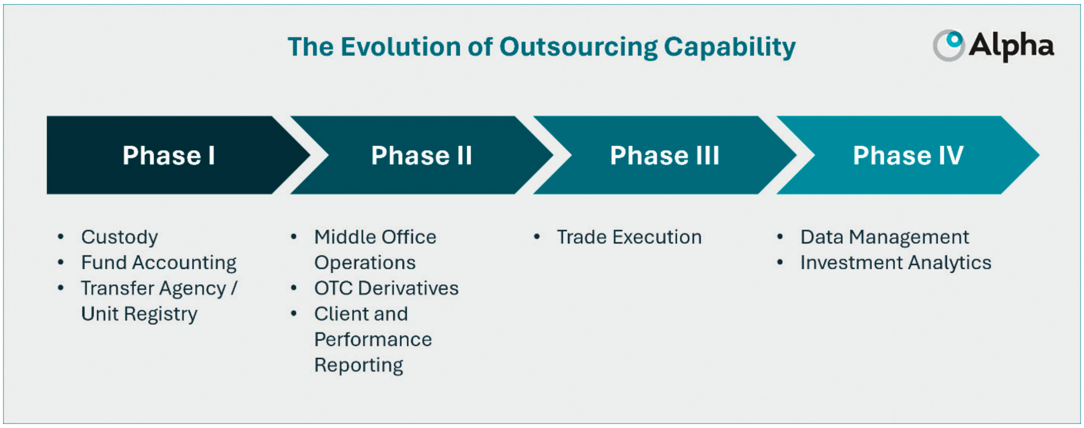

Figure 1 The evolution of outsourcing capability[1]

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IV) is no longer significantly about people and process, however, but rather places a significant reliance on technology and data.[3] This reliance on technology and data is further fuelled by the need of asset managers and asset owners to constantly integrate technology innovations in their investment processes, from dealing with larger amounts of data (which continues to increase with the advancements in ESG investing) to enabling automations and artificial intelligence (AI).

The evolution of outsourcing in the asset management industry has been marked by four distinctive phases, each progressively expanding the scope and sophistication of services offered. While the outsourcing of functions allows asset managers and asset owners to focus on their competitive advantage and seek to deliver investment returns for their clients and members, it also presents an opportunity for the custodians to rethink their service offerings and delivery models to enable the clients to achieve the same.

For example, in the context of data management, custodians have the potential to provide a compelling service offer. By operating as a custodian, they already house huge amounts of investment data pertaining to their clients and are connected into most sources of market and reference data. Their global reach and ability to achieve economies of scale should mean outsourcing this responsibility to the custodian would be an effective 'no brainer'.

CONSIDERATIONS FOR CUSTODIANS

Despite their strategic expansions, custodians have yet to fully cement this new role as data service providers within the investment community. Unfortunately, the landscape is peppered with stories of unmet expectations, rather than clear success stories.

A survey conducted in 2023 showed less than half of respondents were satisfied with the tools provided by custodians to download and extract investment data.[4] Such challenges have prompted some asset managers and asset owners to reconsider the benefits of custodian-provided services, particularly in areas such as data management and the generation of investment book of record (IBOR).

Figure 2 shows the current sourcing of large asset owners for investment data management, demonstrating a predominant bias towards insourcing these activities.

As a consequence of insourcing the centralised core activities such as investment data management, asset managers and asset owners have had to invest on two fronts:

(1) *People and processes*: Resources required to bring these functions in-house and continue to support the functions as part of their business as usual (BAU) roles in addition to standing up all the necessary processes and governance.
(2) *Technology*: Capital investment required to develop/procure the required technology to conduct the activities.

Both these areas have been part of the advantages of the Phase I and Phase II outsourcing and therefore bring into question the approach that is currently being taken.

'Missed opportunity' for the custodians

The fact that asset managers and asset owners continue to insource key functions such as investment data management despite custodians making significant investments in these areas indicates missed opportunities for the custodians.

For instance, custodians already have access to required data and infrastructure to offer data management services. They have deployed necessary security protocols, uplifted the cyber security measures, and have advanced technology platforms to support the clients. But this has not attracted clients to outsource these activities to custodians.

Figure 2 Asset owners' preference of insourcing versus outsourcing the investment data management function[5]

Furthermore, custodians have invested in specialist resource pools with required skill sets in data science, product engineering, software development and other core technical areas. Ideally, this should allow custodians to provide the service leveraging their resources, expertise and capital investment; however, their ability to deliver change in these organisations has been limited.

So, where do these considerations and challenges leave custodians? A significant shift is required in how custodians have been thinking about developing and delivering their service offerings.

CHANGING THE MINDSET

For custodians to convince clients to buy these value-added services, a fundamental rethinking of their role and operational mindset is imperative. Traditionally custodians are characterised by their conservative, risk-averse nature, focused on safety and reliability; however, the evolving needs of modern asset managers and asset owners demand proactive engagement and, occasionally, a tolerance for calculated operational risks to achieve strategic investment returns.

Unlike other services such as fund accounting and reporting, most newer services being offered by custodians are highly contestable and the case for outsourcing may not be clear. While there may be clear advantages in appointing a custodian for these services (global scale, fewer service providers, simplified internal operating model), adopting the traditional custodian service mindset will not win the argument, and, in fact, may be counterproductive. To be successful, we believe the following criteria will be important:

(1) *Embracing flexibility over rigidity*: The traditional custodian model emphasises scale and robust operational frameworks designed to minimise risk. While these attributes are undoubtedly valuable, they often come at the expense of flexibility and responsiveness. Modern investment strategies, characterised by rapid shifts in market dynamics and investment opportunities, require a service provider that can adapt quickly and offer real-time solutions and data. Therefore, custodians must cultivate flexibility within their operational models, enabling them to respond swiftly to the changing needs of investment teams of asset managers and asset owners.

(2) *Integrating deeply with the investment processes*: Historically, custodians have maintained an arm's length relationship with investment processes, focusing on safeguarding assets and providing back-end support. The increasing complexity of investment strategies, however, necessitates a deeper integration of custodians into the investment process. This means developing a nuanced understanding of the investment strategies, market assumptions and specific analytical needs of asset managers and asset owners.

   Primary demand from the clients for the custodians has been to provide an accurate and 'safe' accounting book of records (ABOR) that has been verified and validated. While this provides immense value for accounting purposes, custodians have the opportunity to climb up the value chain and create instruments of value for investment teams who are looking for something that they can use to make timely investment decisions — an 'unofficial' IBOR.[6]

   An 'unofficial' front office IBOR that includes near real-time trading data, manager transactions and current positional data will allow for timely decision making and risk analysis. Admittedly, the job that this IBOR does, and the success factors, are significantly different from an ABOR; however, this will allow custodians to integrate deeply with the front and middle office operations, thus becoming an indispensable part of the investment team.

(3) *Leveraging technology to enhance services*: The role of a traditional custodian is evolving with the advancement of technology. Going forward, the custodians need to position client demands at the centre of their service model. The custodians will have to wear multiple hats of a technology adviser and a service provider — and will need to switch the hats depending on circumstances and client needs.

The rise of specialised technology providers presents a compelling alternative to traditional custodial services, offering tools that empower asset managers and asset owners to retain control over key functions. This emerging landscape raises two critical questions: are custodians attempting to extend beyond their core competencies and traditional boundaries? And what will be the consequences if custodians do not adapt to the changing environment?

What are the consequences?

Custodians' lack of innovation, slower adaptability and inefficient processes will open the door for their clients to find alternative solutions to their problems, either by developing the solutions themselves (insourcing) or by leveraging specialist technology providers.

A few notable examples include:

(1) Asset managers and asset owners have started to insource a few key activities that were previously provided by custodians, such as performance measurement, attribution and risk (PMAR) models and IBOR creation and management, among others.
(2) Traditionally, custodians provided transfer agency/unit registry services as a value-add service to investment managers. Recently, however, this market has been captured by specialist technology providers across the globe as they catered to emerging client needs more efficiently.

While it may be easy to continue providing an existing suite of 'safe' services to clients — after all, custodians have built their robust infrastructure, global omnipresence and a reputation over decades — there is a significant risk in that stagnation, and it makes the market prone to disruption from more nimble technology players.

This poses an important question: how should a forward-looking custodian think about its transformation?

THE FUTURE CUSTODIAN

To effectively support modern asset managers and asset owners, custodians must embody several transformative attributes:

(1) *Platform orientation*: Custodians should evolve from being a one-stop shop to acting as a robust platform that integrates their services with external technologies. This approach facilitates a seamless ecosystem where asset managers and asset owners can access a mix of in-house and external services efficiently. For example, asset managers and asset owners need to able to choose their own best-of-breed order management system (OMS) and execution management system (EMS) depending on their needs across the value chain, based on their investment strategies, risk appetite and the asset mix they manage, instead of having to stick with a system that comes with the broader relationship with the custodian.
(2) *Technology and service integration*: The future custodians should transition into technology providers as well as service managers, enabling clients to interact dynamically with their data and perform critical business functions through advanced platforms.
(3) *Deep investment process integration*: It is essential for custodians to develop a deep understanding of their clients' investment processes and strategically align their capabilities to support these processes effectively.
(4) *Balancing operational and investment risk*: Forward-looking custodians must be willing to accept higher operational risks when necessary to provide the agility required by volatile markets. This includes offering earlier, albeit less refined, data to facilitate rapid decision making.
(5) *Client-centric solutions*: Custodians must prioritise understanding and addressing the specific challenges and needs of their clients, developing tailored solutions that provide tangible benefits rather than merely offering generic products.
(6) *Adaptive service management*: An adaptive and responsive service model that aligns with client operations is crucial. This involves using automated tools to enhance service delivery and manage exceptions more effectively, providing a personalised service experience.
(7) *Uniformity of client experience*: Clients

investing across various markets face differing service models due to local regulations and practices. As asset allocation shifts towards emerging markets, there is a growing need for a global client service model. Custodians are expected to smooth out local variations to provide a consistent experience, which also aids in integrating digital processes. The significance of local presence and understanding cannot be overlooked, however, as discussed below.

(8) *Leverage global presence*: By leveraging their global presence and experience, custodians can offer valuable insights and guidance to help clients navigate complex regulatory environments and adopt best practices.

HOW ARE YOUR CLIENTS THINKING?

To effectively transition towards the roles a future custodian plays, it is imperative to understand what your clients (ie asset managers and asset owners) are thinking. For an objective assessment, your clients examine the key success factors through the following questions:

(1) *Does my custodian understand my investment process?* Effective custodians should demonstrate a comprehensive understanding of the client's investment life cycle and the specific data and analytics needed to support it. Example: Look for a custodian that customises its reporting and operational support to align with your portfolio's specific investment strategies and risk management protocols. An illustration could be a custodian that provides tailored risk assessment tools that integrate seamlessly with your investment decision-making process.

(2) *Can I move more quickly with my custodian versus me going alone to achieve the desired outcome in a sustainable way?* Where I need to make a change (eg new product, security, market, etc.), will they be the fastest or slowest link in the chain? Do they have the right attributes for rapid change or are they bound by the slower-moving and traditional approach associated with a custodian? Example: Have they established a rapid change capability that can coordinate change with my organisation?

(3) *Will they provide me with a blend of technology and services?* A modern custodian should offer a model where both technology and service delivery are integrated, allowing both the custodian and the client to perform essential business functions interactively. Example: A custodian that offers an advanced online platform where you can not only view but also manipulate data, generate custom reports and conduct simulations to assess potential investment outcomes.

(4) *Can they connect me to best platforms?* Custodians should facilitate easy integration with emerging technologies and manage these connections efficiently, without imposing additional burdens on the client. Example: A custodian that has established application programming interfaces (APIs) that allow for quick integration with a variety of third-party tools and platforms, enabling you to leverage the best available technology without significant in-house development.

(5) *Are they easy and capable to work with?* Is their culture and behaviour complementary to my organisation and are they an enabler or blocker to getting this done? In addition, do the custodians have the required resources and expertise in critical areas of technology, engineering, product development, cyber security and, more importantly, in the functional areas of investments, operations and data management, among others? Custodians ought to build confidence in their clients that they can provide these

services with higher accuracy in a timely manner.

(6) *Is it commercially viable?* Ensure that the custodian's business model is sustainable and offers services that clients value and are willing to pay for. Example: Does the commercial model deliver a positive return on investment (ROI) to the custodian or is it being subsidised by other bundles services such as core custody? Where the latter, has the custodian developed the value-add service into a successful multi-client offer, justifying ongoing future commitment and investment?

CONCLUSION

The evolving landscape of asset management has traditionally been supported by the role and operational support of custodian banks. This has supported the servicing ecosystem well and two phases of outsourcing have effectively been met and delivered.

For the completion of Phase 4 outsourcing, a shift from traditional custodial roles to proactive, technology-driven service providers is necessary to meet the dynamic needs of modern asset managers and asset owners. As these financial institutions build crucial insourced functions, custodians must leverage their inherent advantages — access to data, technological infrastructure and global presence — to offer more integrated, client-centric services.

So far, these advantages have not been able to convince clients to holistically partner with the custodians as data partners. Failure to adapt with the needs and expectations of their clients could see custodians sidelined in favour of more agile-minded technology providers with less people-dependent operating models. This missed opportunity underscores the urgent need for custodians to evolve.

To remain relevant and indispensable, custodians must transform into robust platforms that not only secure assets but also significantly enhance the investment processes of their clients. This evolution has begun with an uplift in both technology use and people, but a mindset shift to align more closely with the needs of modern asset managers and asset owners is still needed.

By redefining their roles from traditional safekeepers to proactive technology partners in the investment life cycle, custodians can meet the evolving demands of their clients and maintain their pivotal role in the industry.

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