A Point of View by Oracle Financial Services

Playing Catch-up in Custodial Banking is Not Enough

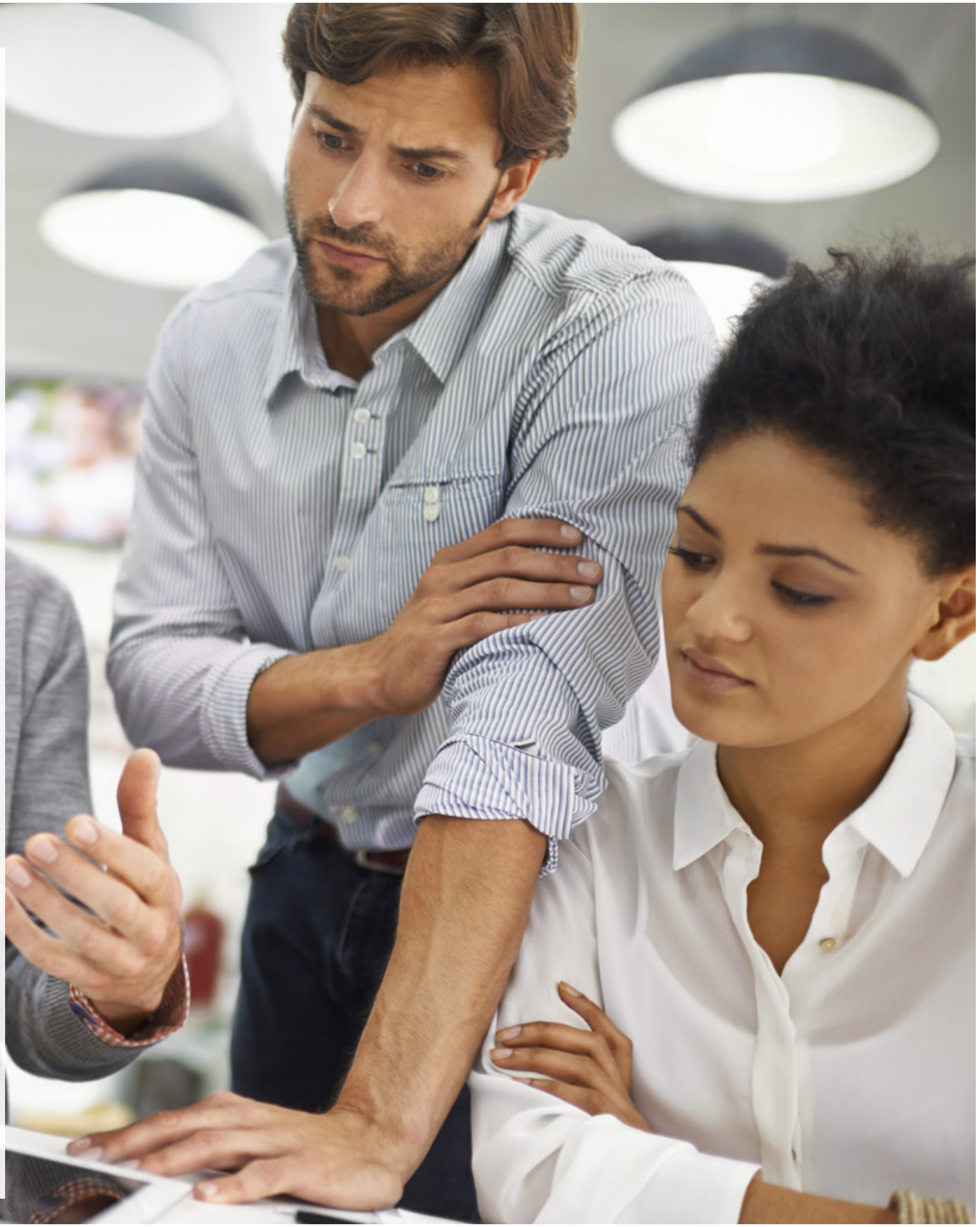
Big Challenges and Big Opportunities for Custodians

Custody banks now have a global glow with the sector's boom yet traditional custodial banking technology architectures may not be designed for the sophisticated demands of customers today.

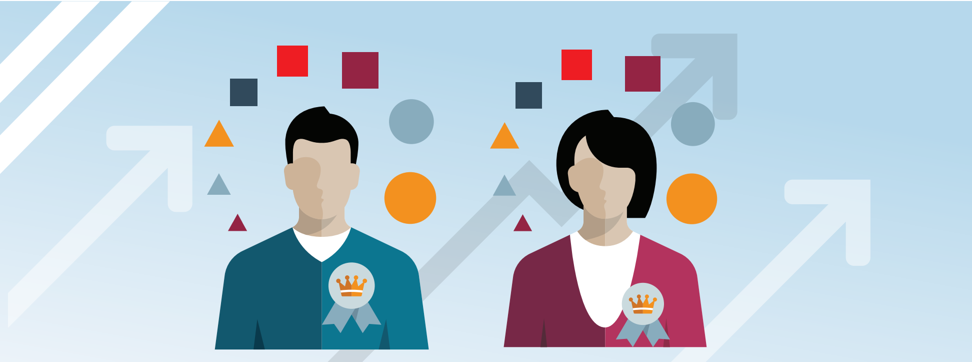
While the custodial banking business has traditionally been transactional in nature with established revenue streams, custody banks are now being forced to re-assess their operations as increasingly sophisticated customers, more complex assets and stringent regulations place pressures on the cost of business.

New banks such as China's banks are also warming up to asset custody as a major contributor of fee income. According to a report released by The Boston Consulting Group and China Everbright Bank Co Ltd, the market is expected to reach 174 trillion yuan in assets by 2020. These new players often enter the market without legacy systems and processes, enabling them to react better to current customer demands.

[1]http://www.chinadailyasia.com/business/2016-08/18/content_15481108.html



Increasingly Sophisticated Customers



Custody banks have traditionally attracted businesses based on their aversion to risk, as asset owners look for a safe place to park their assets. However, today's customers are more cost conscious and are open to dealing with non-bank competition offering solutions with better processes.

Developments in the payments industry are also affecting the way custody banks need to service their clients. Faster payments and increased adoption of ISO 20022 standards offer real-time transaction processing and reduced settlement times from days to seconds.

Cash managers are currently facing operational difficulties such as inefficiencies linked to the process of cash settlements. This can be made more efficient by reducing the number of interactions required between the trading platform and the cash system, as well as through higher straight through processing when such interfaces are required. This would provide the customers a more transparent view of their funds and help manage liquidity more efficiently.

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Corporates can now enjoy efficiency gains from improved liquidity controls and reconciliations. At the same time, there is greater flexibility in changing banking relationships as corporates are no longer locked in with proprietary formats. The custodian now needs to evolve the conversation beyond cash management to improving yields in liquidity and cash reserves.

Customers are also becoming more sophisticated with multiple funds and multiple currency portfolios across different asset classes in different parts of the world.

At the same time, customers now demand a digital experience with real-time updates – one that they are accustomed to in other parts of the business. Customers expect a higher level of transparency and a real-time view of the markets and their assets. They also expect the banks to provide them with the capability to make the best out of their funds by offering innovative liquidity solutions.

Unfortunately, the traditional custodial banking technology architecture is not designed for the sophisticated demands of customers today. The many stakeholders involved in the transfer of assets – from investors, brokers, global to sub custodians – can contribute to billions of dollars in costs and inefficient processes.

Increased Vigilance by Customers and Regulators

Regulators have also started to look into custody banks' financial health, technology investment and operational processes, to ensure that assets managed are not swallowed by a system's breach or bank insolvency. In an era of sustained market volatility, custody banks are more than just custodians of cash and assets – they now need to mitigate the risks for asset owners.

There has been an increased number of lawsuits against custody banks in the recent years. These lawsuits, initiated by pension funds and asset management firms, question over-charging and inefficient processes by the custodians.

For example, foreign exchange orders are often bundled together and clients are then informed of the price after the fact. Custodians have been accused – and successfully sued – for charging clients the worst rates of the day while executing at the best and pocketing the difference.

External Pressures Forcing Transformation

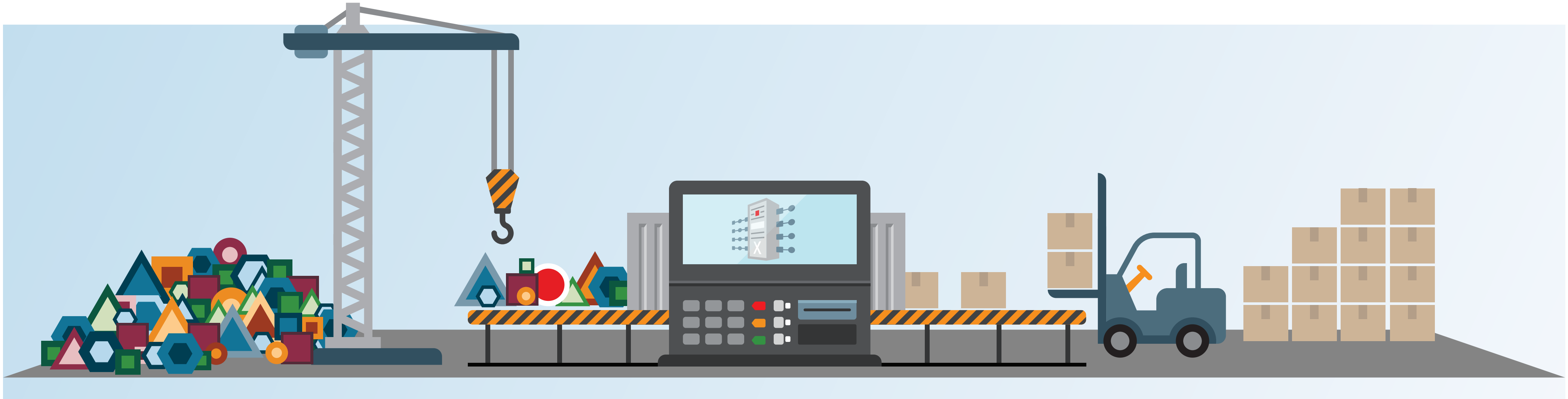
Increased market volatility has caused asset owners to flee to safer asset classes and reduce trading volume, leading to reduced fees. Near zero interest rates have also compressed spreads and net interest income margin of custodians.

While the last decade has seen a larger amount and concentration of assets among fewer global custodians, margins have dropped while cost-income ratios have increased.

Increased market volatility and eroding confidence in the banking system has also forced custodians to re-emphasise trust and transparency in the safekeeping of assets.

These custodians are also faced with the increased burden of regulatory compliance that aim to enhance customer protection and reduce the fallout from another global financial crisis.

Initiatives such as Basel III, the Alternative Investment Fund Managers Directive (AIFMD) and the Markets in Financial Instruments Directive (MIFID) II are putting the pressure on custodians to improve processes and invest in efficiency-enabling technology.



Current Infrastructure is Creaking

The spate of consolidation recently has seen custody banks struggle with a hodgepodge of systems tied together with middleware. Some systems are home-grown while others are so antiquated that there is a lack of technical support as most IT professionals have moved on to newer systems and programming languages.

At the same time, custody banks have to grapple with increased reporting requirements by taking data from different systems and cobbling them together. Unfortunately, they are still unable to extract this same data to gain a competitive advantage.

The scale of a custodian bank is its strength but when it comes to moving forward, legacy systems can hold it back. The technology underlying a typical custody banking environment is at least 30 years old.

At the same time, customers no longer want to wait for banks to consolidate data across multiple systems and demand real-time information and updates on their assets.

Other parts of the bank also want the ability to view customer data in real-time: from the compliance department dealing with reporting requirements to the relationship manager interacting with the customer for a corporate banking service.

Playing Catch-up is Not Enough

To improve profitability and deal with increased regulation and market scrutiny, custody banks will need to re-invent themselves beyond asset safe-keeping and settlement.

The winners of tomorrow are already adapting to this new environment and creating new products and services while addressing changing demands.

Custodians with up-to-date workflows and structures, efficient and reliable data processing and interlinked communications system are better able to service their customers globally across different asset classes.

Technology in this space is moving beyond its traditional role, evolving from operations and processing into providing customer insights. Data analytics offer an opportunity for custody banks to move up the value chain with integrated solutions by sourcing, executing deals and cross-selling across the bank with investment banking and private banking offerings.

The leaders are also starting to leverage their expertise in risk management and assets safekeeping to create new revenue streams in transition management, global network management and prime brokerage services.

Nascent technology such as blockchain or distributed ledger also offer the possibility of shorter settlement times, improved balance sheet efficiency and the ability to share data for regulatory reporting and know-your-customer (KYC) requirements.

The custodians of tomorrow will need to embrace new technology, new services, new revenue streams and new customer segments to thrive in the evolving banking landscape.

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