A perfect storm?

New frontiers for custodians and asset managers
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A perfect storm?

New frontiers for custodians and asset managers

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The custody business is being squeezed by new regulations, low interest rates and sluggish performance from their asset manager clients.

That’s bad enough. But the standard custody business model faces a more fundamental threat. The tasks performed by custodians are increasingly amenable to automation. This is turning custody into a technology-based business, with high fixed costs and near-zero variable costs. Custody is going the way of asset management itself, where the rise of automated passive management is causing assets to concentrate in the largest players, whose scale advantage allows them to charge ultra-low prices. Custodians may be reduced to a handful of low margin, utility businesses.

Yet the advance of automation also provides custodians with opportunities to extend their offering. Once automated, the middle office functions of asset managers can more efficiently be supplied by custodians than by the asset managers themselves. The scale and data advantages of custodians give them opportunities to capture increasing portions of the asset management value chain. But they will do so only if they adopt a new, non-transactional business model.

The 1990s custodian business model is coming to an end

The current custodian business model emerged in the 1990s. Custodians provided asset managers with outsourced back-office functions, such as safe-keeping, settlements and fund accounting. This allowed asset managers to focus their efforts on sales and portfolio management. And custodians’ scale meant they could charge asset managers less than the outsourced tasks would cost to do in-house.

Competition drove custodians to price their core offering on thin margins, which they subsidized with wide margins on value-added services, such as securities lending and FX transactions. But regulators’ drive for transparency is making this pricing model unsustainable. The revelation of super-profits on FX transactions has resulted in a wave of mispricing litigation. Bank of New York Mellon, for example, has been fined $900 million on an average annual FX revenue of $670 million. And securities lending was effectively ended by post-crisis regulations, removing 7-8% of the 2007-09 revenue pool. [Exhibit 1.]
High frequency trading (HFT) and the growth of passive funds (which are expected to account for 35% of US equity investment this year) are also taking a toll. Both strategies increase the number of trades for any given quantity of assets under custody (AuC). Since 2010, the value of shares traded globally has increased by 23%, while the number of trades has increased by 48% and the average ticket size has decreased by 17% [Exhibit 2]. This increases custodians’ cost-income ratios, because their costs are driven by trades and their incomes by AuC. And, with interest rates currently close to zero, the net interest income custodians once earned on their cash holdings has all but disappeared.

Exhibit 2 | Average ticket size has decreased significantly driven by the growth in High Frequency Trading and Passive Funds

Decreasing ticket size increases custodian’s cost-income ratios, as costs are driven by number of trades and income by AuC.
Demand for custodian services is simultaneously subdued. In developed economies, non-market related growth in the asset management industry is sluggish. Net new money has been steady at 1.5% of assets under management (AuM) p.a. since 2012 [Exhibit 3]. While revenues and costs have been declining as a percentage of AuM, margins have stayed flat. However, the growing burden of new transparency regulations – such as Australia’s RG97, which requires funds to disclose all fees and costs – will continue to increase the pressure on margins for the foreseeable future. As asset managers struggle with their own margin compression and compliance costs, they will be looking to pass some of the pain on to their custodians.

Custodians are, of course, taking actions to counteract these difficulties. Most obviously, they are trying to cut costs by adjusting staffing ratios, off-shoring, digitizing and encouraging self-service. They are also adapting their pricing to the new regulatory environment, with minimum annual fees for small (usually unprofitable) clients, regulatory fees, a transparent menu of add-on service prices, fixed margin FX, and pre-digital prices for processes that remain non-digital.

These are moves in the right direction. But because custodians are yet to fully appreciate what that direction is, they have not moved as far as they should. Such initiatives need to be part of a more fundamental repositioning.
From transactor to solution provider

The regulatory and current interest rate environments present custodians with immediate challenges. But these should not distract senior managers from the more fundamental challenge presented by a changing technological environment.

The continued advance of automation and low effort self-service is undermining transaction-based business models. Travel agency is an example. Buying a flight online involves less effort than visiting a travel agent, and the marginal cost of the transaction for the website owner is usually zero. Travel agents cannot compete in simple flight purchases. That’s why there are now fewer travel agents and why those who remain provide different services. They may have started calling themselves “travel consultants” in the 1990s, but now they really are. A travel agency for a corporate client doesn’t take orders for flights. It provides a simple way for client staff to buy flights within a package designed to get the best value out of business travel. It is an advisory relationship supported by transactional technology.

Custodians face a similar technological challenge and must respond in a similar way. Most of their core functions are already automated or soon will be. For example, reconciliations is still one of the most labour intensive services provided by custodians. Robotics and simple AI can replace humans for many of the activities involved, and distributed ledger technology (blockchain) promises to eliminate the need for reconciliations all together. Self-teaching algorithms may soon be able to replace humans in performing net asset valuations, which is now a labour intensive and costly process for custodians.

As this trend toward automation continues, custodians must shift from a business model based on executing transactions to one in which they work with clients to solve their problems.

The new operating model

On this new model, custodians will approach clients in a spirit of partnership, working with them to design products or systems that meet their end-to-end needs. This will be easier if custodians shift their operating model from client-type to asset-class, since the latter determines custodial requirements. Indeed, some smaller custodians may choose to specialise in certain asset classes, such as those where comparatively low volumes make scale less important. With a renewed focus on what services are being consumed, clients can then be segmented by size (or willingness to pay) to provide product suites aligned with their preferences, ranging from customized full-service solutions to self-service models.

These segmented offerings should extend beyond the services now available. Custodians can take yet more off the hands of asset managers by providing

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collateral management, middle office functions, such as risk measurement, and enhanced reporting, especially for regulatory purposes.

The vast quantity of data that custodians’ activities naturally generate and capture gives them an advantage in these areas. By applying advanced analytics techniques to this data, they will be able to provide their clients with value added services they could not produce for themselves. The other advantage is scale. As technological advances allow middle office functions be automated, they become a fixed cost which it then makes sense for most asset managers to outsource to large-scale suppliers.

If custodians don’t move into these spaces, others will, including fintech firms and asset managers with sufficient scale. Blackrock (with its Aladdin offering) and Northern Trust (Omnium) are already using their digital technology to insource the middle office functions of smaller asset managers, earning margins of up to 30%.

Pricing will need to be adapted to this new model. As noted, regulators are driving more transparency and, with it, an end of product or service cross-subsidies. Combined with generally declining margins, this will require improved price discipline from custodians. Pricing must be based on estimations of customers’ propensities, with regard to both cost-generating activities (such as trade frequency and the use of non-digital channels) and willingness to pay. Account performance must be regularly monitored, with underwater accounts avoided through the use of volume-based pricing schedules.

Finally, custodians must acknowledge that technology is at the heart of what they do, and organise themselves accordingly. They should be more like tech firms and less like banks, with cross functional teams that assemble, split up and reconfigure according to the development needs of the time. And, like the clients they serve, custodians must be willing to outsource what they have no advantage at doing in-house. This could mean the largest custodian banks coming together to form an industry utility for standardized services on which they cannot compete.

Embracing big data analytics, AI and robotics will require a different talent pool from the one custodians have today. Their entire talent model – recruiting, hiring, development and their employee value proposition – will need to change if custodians want to attract, retain and develop the best tech talent.

Globalisation and sub-custodians

The custody business relies on the asset management business, which is seeing new money grow more slowly in the most developed markets, such as North America and Europe. This is a result of an increasing population of retirees, who are natural “dis-savers”, combined with an ultra-low interest rate environment.
In emerging economies such as China and India, however, savings rates are much higher and AuM are growing rapidly. Most large Western custodians do not operate in these countries. Instead, they rely on sub-custodians, often splitting their business between several. Custodians might try to capture the growth opportunity in these markets by competing directly with their sub-custodians. However, the effort involved, especially to obtain a banking licence and to fulfil increasingly local regulatory requirements, will make this an unattractive strategy for many.

A more attractive option for custodians looking to enter new markets may be to partner with a sub-custodian, promising it the entirety of their business in that market. By exporting their new technology and business model to the sub-custodian, they can capture market share in the emerging market. The scale benefits for the domestic custodian should result in significantly lower prices for its partner.

In the (much) longer run, however, there is no reason why such arrangements should be necessary. A custody business could be global in the way that Google and Facebook are. A firm with its servers and all its non-sales staff in New York, Silicon Valley or London’s “Silicon Roundabout” could provide its services to an asset manager anywhere in the world. It is the legal barriers created by domestic financial regulations, not technological limitations, that now stop custody from globalizing in this way.

**Conclusion**

Custodians are in the business of doing what asset managers would otherwise do for themselves. Technological advances do not change this fact. On the contrary, they create new opportunities for outsourcing asset management operations. But custodians will capture these opportunities only if they recognise that they are suppliers not merely of transaction processing but of technology solutions. They must work with their clients to develop technology, services and pricing schedules that maximise the degree of outsourcing that is mutually beneficial. In what may appear an ironic implication of automation, custody must become more of a relationship business.

To survive, custodians will need to recognise that they are suppliers not merely of transaction processing but of technology solutions.
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