

SELECTING A CUSTODIAN: A DAUNTING TASK!

Institutional investors are known as the “Buy-side” within the financial services industry. This is due to their need for investment assets, though they also sell investment assets. Types of institutional investors in the Buy-side category include: Asset Managers, Bank Trust Offices, Endowments, Family Offices, Foundations, High Net Worth Investors, Insurance Companies and Investment Advisors.

All Buy-side firms, at some point, must select a Custodian. A host of critical tasks are performed by Custodians, least of which is custody of your assets. The approach outlined in this paper, ensures the best outcome by following a structured process. This approach is appropriate for Buy-side firms selecting their first custodian as well as one considering replacement, or the addition, of a custodian.

The first step is formation of a project team that will be responsible for the evaluation and selection of the custodian. Senior business, accounting, compliance, internal audit, operations and technology staff should be on the team to represent their interests. We also recommend that a senior manager be part of the team, or be the project sponsor, to ensure that the process has the support of management.

The team, once in-place, should meet to review their individual objectives and if appropriate, form mini teams to address specific issues related to the project. Meeting should be conducted on a regular schedule to ensure the flow of information across project and mini-teams.

Our **five phase** approach begins with developing the firm’s profile including their objectives, services required, technology application support and near- future business plans. Based on this profile, a request for information (RFI) is prepared and sent to potential custodians. Completed RFI are reviewed and leading candidates are selected based upon their responses. Meetings with, and visits to the offices of, the leading custodians are scheduled. The final phase begins with scheduling a meeting with the leading custodian candidate to negotiate the contractual arrangement and fees and concludes with execution of an agreement.

The five phases are:

1. Identify custodial service requirements and potential custodians
2. Develop request for information (RFI) – send to selected custodians
3. Review and evaluation of completed RFI
4. Schedule meetings and on-site visits with potential custodians
5. Select custodian and begin contract negotiation

A FIVE PHASE APPROACH TO SELECTING A CUSTODIAN

The first step in Phase One is development of the profile of required custodial services. Each service should be defined noting any unique processing or data requirements. All services should reflect whether it is a 'must have' or 'nice to have'. This indication will allow you to establish the minimum level of service as well as recognize and assess services that have a positive impact on your business. Examples of the topics usually identified include:

- a) Identify asset classes currently held
- b) Define the range of basic and custom services required
- c) Assess plans to expand services offered or investing in new asset classes - when
- d) Determine expectations regarding custodian services - country or region coverage, trade execution, derivatives processing, specific support of investment strategies and foreign exchange
- e) Ascertain any specific custodians to consider - develop a list of potential custodians - number can range from 6-10 - 3-5 is ideal

The primary deliverable of Phase Two is preparation of a request for information (RFI) to be sent to potential custodians. The RFI is an efficient method of collecting information from potential custodians. The RFI should stand alone and be self-explanatory. The purpose is to cast a wide net to gather information without face or telephone time.

But it does require that the requirements are presented clearly. Questions should be structured to ensure a concise response with an appropriate level of detail defined. Avoid questions that may elicit a one word response from custodian A and a five paragraph response from custodian B. The RFI should also include the due date by which the RFI responses must be received.

The following is an example of the issues included in the RFI:

- a) Location of main operations center
- b) Current clients
- c) Financials: revenues, service and account & transaction fees

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Review and evaluation of the RFI responses is the primary focus of Phase Three. The first step is to check which custodians have submitted the RFI response. A follow-up call to non-replying custodians may be made to ensure their response was not misdirected. Next is a review to verify that each question was addressed with clear and concise detail. Follow-up protocol to clarify responses is up to the team, some decide not to perform any, while others exercise greater flexibility.

RFI responses are ranked with a numerical value. An example of this is a zero for unacceptable response, a three to reflect a mid grade and a five for fully addressing the requirement. Each potential custodian will have two scores, one each for the “must have” and “nice-to” have defined during Phase One. At this point potential custodians with lower ranking scores are usually dropped from further consideration, keeping the top 2-3 candidates.

The focus of Phase Four is a close-up examination of the remaining custodian candidates. Face to face meetings with the custodian candidates are scheduled so the team can explore in detail how the custodian operates and supports their clients. This also allows the project team to address their individual interests from a business, technical and operational perspective. Team members can identify the financial, compliance and control issues that will impact the relationship. Escalation procedures for resolution of exception and problems can be explored as well.

On-site meeting at the potential custodian’s primary operations centers, if at a different location, are scheduled so that the team can meet staff responsible for supporting their business. Service level agreements can be addressed as well during these custodian candidate meetings. At the conclusion of this phase, the leading custodians become apparent.

In Phase Five, the team meets to discuss the strengths and weaknesses of each of the potential custodians. The leading custodian, is identified and meetings are scheduled to negotiate an agreement.

Negotiations typically address standard and custom services required and any technical application development needed to meet any unique requirements. Fees are a sensitive topic for both parties and require tact and flexibility from both parties. If appropriate, the conversion process is discussed so that the Buy-side firm is aware of the process and is comfortable with the candidate custodian’s ability to make the process seamless with minimal interruption to the Buy-side firm.

The final step is the transition from being a candidate custodian to being “Our Custodian”. We hope you find this approach helpful and wish you good luck!