Executive Summary
The fact that banks in the custodian market (BNYM, State Street, JPMorgan, etc.) no longer call themselves custody service providers is symptomatic of significant industry changes already underway. The industry sands are steadily shifting, as the custodian’s traditional role evolves and ascends the value curve of investment management. The forces of regulation, technology and competition are reshaping the dynamics between asset managers (i.e., mutual funds, hedge funds, ETFs and sovereign wealth funds) and custodians.

In the “new normal,” asset managers face relentless headwinds to generate alpha and to grow assets under management. With revenues under pressure, they are actively re-examining the operational efficiency of their middle and back offices, to shore up profitability. Custodians are facing increasing competition from Central State Depositories (CSDs), which is resulting in cannibalized margins and commoditized services. Additionally, with traditional securities lending business revenues under stress, custodian banks have the right incentives to offer more value-added services and bolster revenues.

Custodian Ascendance
Regulatory and market forces have dealt the cards, and the advantage goes to the custodians. In our view:

1. Custodians will play a partnership role with asset managers and take a larger share of trade intermediation, especially in middle-office activities.
2. Winners will be differentiated by continued investments in upgrading the platform infrastructure to offer standardized yet flexible, componentized, utility-like service offerings.
3. The most successful service providers in the middle-office space will have a client-centric mindset and offer a differentiated client experience through a world-class service delivery platform.

Multiple forces are pushing custodian banks away from a traditional, scale-led, low-cost business model of providing commoditized services. Such services include safekeeping of assets and trade settlement to value-added, middle-office functions like transaction and information management.
With safekeeping of assets and trade settlement considered to be core service offerings, custodian banks have, over several decades, built a formidable global franchise. The heft provided by the scale of assets under custody has enabled them to compete on costs and augment revenues through other income streams, such as securities lending, foreign exchange transactions and treasury operations (see Figures 1 and 2).

**Disruptive Forces**

Competition, commoditization, regulations and other market forces have created compelling economic incentives for custodian banks to stretch their service-offering value chain to remain relevant and viable. For example:

1. The financial crisis (and its aftermath,) led to a series of events – including a decline in securities lending activity, near-zero official interest rates in the most advanced economies and a tough foreign exchange market – which continues to stress revenue models.

2. The advent of CSDs as the lowest-cost service provider has commoditized services, such as safekeeping, as well as cannibalized margins.

3. Changes wrought by regulations such as AIFM (alternative investment fund managers directive) and T2S (Target2-Securities) will have a material bearing on compliance and operating costs.

Market and regulatory forces are driving asset managers to farm out more and more of their investment management operations to third-party providers and adopt a more flexible cost structure to ride out tough times.

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**Assets Under Custody and Market Share for Top Custodian Banks (2009)**

![Chart showing market share for top custodian banks (2009)](chart1)

_Nearly 60% of the global market is shared among the Top 4 players. The global custody market totaled $104 trillion_

**Revenue Stream Composition of Custodian Banks (2009)**

![Chart showing revenue stream composition for custodian banks (2009)](chart2)

_Fee revenue represents 75%-80% of total revenues for the trust banks_

*Sources: BNY Mellon corporate reports and Bernstein Research*

*Figure 1*

*Figure 2*
Falling revenues, cost pressure, regulations, growth pressure and increased demand for transparency is causing unprecedented stress on asset managers’ middle- and back-office operations.

Asset managers have yet to recover fully from the 2008-2009 financial crisis. While asset prices are back to pre-2007 levels, their revenues are at 70% of those levels.

With traditional revenue sources coming under pressure, asset managers are diversifying into exotic products and asset classes, such as real estate and hedge funds, to generate new revenue. This creates pressure to build or upgrade IT platforms and stretches support in the middle- and back-office. Socially responsible investment mandates that need to be monitored to ensure fund managers’ adherence is creating additional pressure on the middle office.

A raft of pending European Union regulations, such as the AIFM directive and Uctis 4, is increasing compliance costs (i.e., investments in IT platform upgrades, which boosts CapEx), while adding to middle-office support expenses.

The scope and scale of the Madoff fraud – and the resultant call for greater transparency and governance – is forcing asset managers to re-examine how pricing, auditing and accounting functions are performed.

Institutional investors today are at the forefront of these changes, demanding the involvement of third parties when it comes to valuations of complex or non-liquid assets, such as over-the-counter derivatives.

### Forces of Disruption

<table>
<thead>
<tr>
<th>Forces</th>
<th>Events</th>
<th>Impact</th>
<th>Implication</th>
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<tbody>
<tr>
<td><strong>Custodians</strong></td>
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<tr>
<td>Market</td>
<td>• Seizure of securities lending market</td>
<td>• 50% drop in market volumes</td>
<td>• Material impact on business revenue</td>
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<td></td>
<td>• Ultra-loose monetary policy</td>
<td>• Near-zero official interest rates</td>
<td>• Material impact on treasury income and revenue</td>
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<tr>
<td>Competition</td>
<td>• Advent of Central State Depositories (CSDs)</td>
<td>• Commoditized core traditional services like safekeeping and trade statement</td>
<td>• Cannibalized margins</td>
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<tr>
<td>Regulation</td>
<td>• AIFMC*</td>
<td>• IT platform upgrades</td>
<td>• Higher cost of compliance and operations</td>
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<td>• T2S**</td>
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**Figure 3**

<table>
<thead>
<tr>
<th>Forces</th>
<th>Events</th>
<th>Impact</th>
<th>Implication</th>
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<tr>
<td><strong>Asset Managers</strong></td>
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<tr>
<td>Market</td>
<td>• Asset market collapse and subsequent recovery</td>
<td>• Asset prices are back to pre-crisis levels</td>
<td>• Material revenue and profit impact</td>
</tr>
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<td></td>
<td>• New products/asset classes (real estate, hedge funds)</td>
<td>• Revenue is at 70% of peak windows</td>
<td>• IT capex costs</td>
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<td></td>
<td></td>
<td>• Investment in new IT platforms, Middle-/back-office support</td>
<td>• Increased support costs</td>
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<td></td>
<td></td>
<td>stretched</td>
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<tr>
<td>Socially-Responsible</td>
<td>• Monitor fund manager adherence to style mandate</td>
<td>• Additional stress on middle office</td>
<td>• Stretched support costs</td>
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<tr>
<td>Investment Mandates</td>
<td></td>
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<tr>
<td>Regulations</td>
<td>• AIFM*</td>
<td>• Upgrade IT platforms</td>
<td>• Increased compliance costs</td>
</tr>
<tr>
<td></td>
<td>• Uctis IV</td>
<td>• Middle-office support stretched</td>
<td></td>
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<tr>
<td>Corporate Scandal</td>
<td>• Madoff fraud</td>
<td>• Demand for greater transparency and governance</td>
<td>• Review pricing, auditing and accounting functions</td>
</tr>
<tr>
<td>Investor Activism</td>
<td>• Market seizure for complex securities products (OTC)</td>
<td>• Demand for independent valuations of these complex securities</td>
<td>• Review valuations and performance encasement functions</td>
</tr>
</tbody>
</table>

* AIFM - Alternative Investment Fund Manager’s Directive  ** T2S: Treasury 2-Security

Source: Cognizant Research Center

**Figure 4**
While market and regulatory dynamics are forcing asset managers to outsource more investment management functions, custodians with committed human capital, scale and operating leverage are ready to move up the value curve.

Starting with custody and fund accounting services, custodians have, over the last decade, gained a deep understanding of the investment management landscape. They have more mature capabilities, scale and efficiency, and are ready to take on the operational, regulatory and technology risk that asset managers seek to outsource.

The outsourcing model has matured to such an extent that asset managers are today boldly embarking on a new wave to outsource not only commoditized back-office processes but also client-facing, middle-office services such as performance measurement and valuation (see Figure 5, below).

While cost savings will be critical, building strategic capability is the prime driver for middle-office outsourcing. Given the breadth of asset classes, complex products and regulatory changes, today’s asset managers need to react faster than before. As a result, middle-office outsourcing has evolved from a purely cost-driven proposition, to a strategic one.

It is critical to understand that custodians have made huge investments in standardized global platforms for back-office outsourcing (e.g., custody and fund accounting services) that asset managers already take advantage of. They have built-in advantages and therefore are well positioned to offer middle-office services to their asset management brethren (see Figure 6, next page).

Outsourcing Choices

The outsourcing market has reached a level of maturity where asset managers can either choose from bundled service offerings or cherry-pick specific stand-alone components.

**Bundled services:** A “bundled” outsourcing solution is typically a cost play that will include multiple back- and middle-office processes at scale. Commonly bundled services include core activities such as trade processing, corporate action management, reconciliations, cash management and portfolio recordkeeping.

**Component services:** “Component services” offer asset managers the opportunity to evaluate a service before committing to a long-term, broader relationship. It also offers the shortest path to accessing new features and services that will be critical to support complex investment types and new product launches.

We see outsourcing gaining traction in specialized functions such as OTC derivatives processing, collateral management, data management and client reporting, which will benefit firms seeking operational efficiencies, stronger regulatory compliance and better technology risk mitigation.

### Middle-Office Services Value Chain

<table>
<thead>
<tr>
<th>Lower Value More Commoditized</th>
<th>Trade Processing</th>
<th>Portfolio Record-Keeping</th>
<th>Collateral Management</th>
<th>Analytics</th>
<th>Market Communications</th>
<th>Higher Value More Differentiated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reconciliation</td>
<td>Corporate Actions</td>
<td>Derivatives Processing (valuation)</td>
<td>Performance Attribution Risk</td>
<td>Client Communications</td>
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</tr>
</tbody>
</table>

**Pillars of Success**
- Advisory/Knowledge-Based Services
- Technology
- Human Capital
- Process (Capacity and Control)
- Data Management

**What’s Next?**
- Trading?
- Stay tuned...

*Source: Northern Trust*  
*Figure 5*
Custodian Advantages

Custodians and technology service providers must continue upgrading current platforms despite continued tough market conditions, as well as offer flexible solutions to differentiate and maintain competitive position.

Asset managers clearly see technology gaps in real-time reporting for the front office, reconciliations (lack of automation), data warehouse capabilities and management reporting. Many custodians are addressing the inadequacies of the current, often siloed, IT infrastructure. Addressing this critical gap and building a standardized, integrated, flexible platform that can support back- and middle office-functions will add cutting-edge competitive capabilities to custody service providers.

New Technologies

Leading technology service providers, such as Advent, Eagle and Simcorp, offer compelling solutions in areas such as derivatives processing, workflow, data management and management reporting through the software as a service (SaaS) model. These hosted solutions provide asset managers with the flexibility to outsource application maintenance to third parties, while retaining complete processing ownership.

Custodians and third-party service providers must demonstrate sustained operational excellence and offer a differentiated client experience to gain more middle-office work and sustain the next leg of growth.

Mindset Makeover

Service providers that can deliver material operational improvements, improved front-office support, enhanced performance reporting and higher quality data will differentiate themselves and get a leg up in this space.

Asset manager surveys² clearly highlight the need for service providers to reorient the way they sell and provide middle-office services. Successful service providers will shed the custodian’s view of the world in favor of the asset manager’s view.

Economies of Scale

The changing dynamics of the custodial services space is forcing some competitors to embrace business models that would have been unthinkable a few years ago.

One leading custodian, for example, offers a unique value proposition by integrating its back-office and middle-office services onto one platform. By removing the disconnect between the middle office and back office, many problems are remediated, including cost, inefficiency and computing errors.

This custodian also realizes material operational efficiencies by leveraging a single technology platform and operations group that can work across multiple business lines, such as insurance products, institutional business and mutual funds.

From the client standpoint, the quality of processing and information is greater, since all work is performed on a single integrated platform.
of the world. Winners will become an extension of the investment manager’s operating model by completely aligning with the asset manager’s objectives and offer customized solutions.

Asset managers have specific mandates to re-evaluate their middle-office operations and identify opportunities to save money, improve quality, rationalize technology and service new products (see Figures 7 and 8).

A total of 86% of asset managers (see Figure 9) rank accuracy as the most important service attribute, followed by speed and cost. This underscores the criticality and sensitivity of middle-office operations.

The Road Ahead
As the securities operations market continues to consolidate, we see custodians taking on a greater share of the securities trade intermediation – especially middle-office functions.

The winning custodians will:
• Move away from the current custody-centric mindset and IT platforms and offer client-centric solutions.
• Enable asset managers to test middle-office outsourcing waters by offering flexible, component-based solution and highly standardized, utility-like middle-office solutions.
• Partner with IT product vendors and specialist offshore services firms with middle- and-back-office service capabilities to offer market-leading solutions and practices.

Successful service providers will shed the custodian’s view of the world in favor of the asset manager’s view of the world.

Accuracy is Top Priority

Source: Middle Office Survey, Beacon Consulting Group, 2009
Survey base: 100-plus asset management companies
Figure 9

Top 15 Middle-Office Functions
1. Account Setup
2. Performance Reporting
3. Management Reporting
4. Trade Processing & Settlements
5. Corporate Actions
6. Reconciliations
7. Third-Party Custodian Management
8. Collateral Management
9. Client Statements
10. Posting Cash Transactions
11. Portfolio Accounting
12. Cash Management
13. Information Delivery
14. Data Warehouse
15. Compliance

Source: Beacon Consulting Group
Figure 7

Valued Middle-Office Outsourcing Services
1. Dashboard Reporting
2. Risk Management Reporting
3. Management Reporting
4. Start-of-Day Packages
5. Real-Time Performance Reporting
6. Enterprise Data Management

Source: Beacon Consulting Group
Figure 8
Footnotes

1 Alpha is a risk-adjusted measure of the so-called “active return” on an investment. It is the return in excess of the compensation for the risk borne and, as a result, is commonly used to assess active managers’ performances. Often, the return of a benchmark is subtracted in order to consider relative performance, which yields Jensen’s alpha.


Bibliography


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