As asset managers and asset owners continue to seek a greater universe of opportunities, this trend will likely continue to accelerate and evolve. With these opportunities come challenges for operational executives.

Operational areas that are generally well established, tightly controlled and routine for developed markets are anything but when it comes to less mature markets.

Traditional back-office functions such as trade settlements, tax reclaims, entitlements, foreign exchange and corporate actions are usually much more complex, risky and cumbersome when dealing in emerging and frontier markets. To successfully operate in these markets, asset managers should team up with custodians that have the mission critical qualities of deep local market experience, sound sub-custodian networks and robust functional capabilities.

**LOCAL KNOWLEDGE**

Industry best practices are not always well established in emerging and frontier markets. Leading custodians can help shape the marketplace by participating in local market industry groups, meeting regularly with market regulators to promote reform and enhancements or generating thought leadership focused on local market topics of concern to their clients, among other actions. Although these activities may not manifest themselves directly to clients daily, they do have long-term impact. For example, by staying close to regulatory developments, custodians can keep their clients informed on a timely basis, offer insights regarding how proposed changes will impact their clients and provide recommendations on how to react.

Coupled with industry activism is the prerequisite for local knowledge of the daily operational requirements, practices and customs which are part of these markets. How global custodians obtain, utilize and disseminate this information can take on various forms. Successful custodians typically employ a regional expert who coordinates with sub-custodians. Sub-custodians leverage a skilled workforce that is native to the region. These employees speak the language, know the culture and have developed relationships based on mutual understanding. The effectiveness of these direct and indirect resources should not be underestimated and could be a material differentiator between custodians.

Regardless of how information flows from the source to the client, it’s important to have comfort in the global custodian’s local market domain experience and to know how meaningful insights are communicated to the client. When assessing these softer elements, asset managers should take into consideration how much they will rely on the custodian versus the custodian’s ability to provide fit for purpose intelligence. Without local knowledge and guidance, foreign investors may find themselves at a disadvantage to domestic market participants or worse, inadvertently missing regulatory requirements.

**SAFEKEEPING OF ASSETS**

Another important consideration when assessing global custodians is the safekeeping of assets. Many times, this is considered as an afterthought in developed markets but is of critical importance in emerging and frontier markets. Most major global custodians utilize a mix of direct custody and sub-custodians. For instance, they may be direct in the U.S., Canada and the U.K., while utilizing a network of sub-custodians for all other markets. Very few global custodians are direct in more than a dozen countries.

The risk profiles of these sub-custody networks differ between players. Some global custodians choose to indemnify clients from losses related to the financial failure of a sub-custodian, while others expose clients to the risk or put caps on liability. To mitigate the risks of sub-custodian failure, global custodians generally conduct extensive due diligence when selecting sub-custodians and on an ongoing basis throughout the relationship.
Understanding the due diligence process, and a client’s liability exposure in the unlikely event of a failure, are significant factors.

Underlying the sub-custodian network is the account construct that is used to maintain assets at the local depository. The primary safekeeping custody constructs at the depository level come in two forms: “omnibus” and “segregated”. In an omnibus arrangement, all clients of the custodian with similar tax statuses are consolidated under the custodian’s (or sub-custodian’s) name at the local depository. Under the segregated model, securities are held at the local depository in the name of each client. In many markets, the safekeeping construct utilized is at the discretion of the custodian and/or the custodian’s clients. In certain markets, there is no choice since the market dictates which arrangement is allowable.

The safekeeping arrangement and available options are differentiators between global custodians. Asset managers must have a clear understanding of which structure they are subject to and the risk parameters of each. When a choice does exist, the input of legal experts and custodian domain experts is required to support fact-based decision making and risk assessment. Some global custodians will favor or mandate one arrangement over the other. From the client’s perspective, this may limit their options and should be carefully reviewed during due diligence. For each arrangement, strengths and weaknesses exist that should be weighed for each client’s situation.

KEY CAPABILITIES
Regardless of the in-scope markets, custodians must efficiently process the core back-office functions required to settle transactions, account for entitlements and custody assets. In emerging and frontier markets, many of these functions require in-depth local market knowledge, a strong control environment and supporting technology.

For example, consider the impact of taxes on investment performance. In many emerging markets, tax withholding on dividend income can eat into returns, and filings must be submitted to claim these taxes for tax exempt investors. In addition, the proper segmentation of custody accounts is required by the custodian to enable the tax reclaim process or avoid the withholding at the outset. Each market is different which makes extensive domain experience in each market extremely valuable; some global custodians have more experience in certain markets than others.

In many emerging and frontier markets, the generally simple tasks of entitlement processing, and dividend accrual and collection can become a complex and high-risk function. Many markets have extended time periods between ex-date and pay-date which can impact profit and loss from foreign exchange exposure until income can be repatriated.

In addition, information gathering can be a manual, cumbersome process with uncertain data sources. The levels of capabilities, control, automation and domain experience in this area can vary by custodian.

Another area of differentiation for global custodians is regarding foreign exchange (FX) transactions. A number of emerging markets (Malaysia, India, China, etc.) have complex protocols, regulations and requirements regarding FX transactions by foreign investors. In some markets, global custodians are the only access point for these transactions and the services they provide are important elements to the trade lifecycle. Skilled service providers know the local market dynamics and have developed operating models and technology to support FX activities. FX is a high-risk area that requires the right partner or partners. Similar to tax reclaims, having a presence in the market and deep local knowledge are important success factors.

SERVICE MODEL AND OVERSIGHT
Possessing extensive domain experience, optimal asset safekeeping structures and robust functional capabilities must be paired with a client service model that is tailored to meet each client’s unique business model and requirements. Due to the size, scope and complexity of custody in global markets, navigating the service provider’s enterprise, including the sub-custody network, can be challenging without an appropriate client service model. This is especially true with a large, complex asset manager.

Effective models provide direct coverage by client service specialists and relationship managers that are familiar with each client’s business, and possess broad, high-level domain experience in the markets and in-scope assets. Augmenting these resources are the local subject matter experts who can go deeper into matters involving their territories. The right mix of dedicated service resources, coupled with access to subject matter experts moderated and coordinated by experienced relationship managers, could yield a successful client experience.

Taking a thoughtful, long-term, strategic approach to selecting the right custody partner or partners can be critical for asset managers and owners who are expanding into new markets and/or increasing allocation into non-traditional markets. While custody is considered by many to be a commodity for developed markets, it is a mission critical value-added service in emerging and frontier markets. From this perspective, the investment in sourcing the right custody partners from the outset could yield operational alpha for years to come.
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