Safe custody - What Happens if Your Custodian Goes Bust?

by David Main and Niamh Ryan

The past two years have seen a number of well-known financial institutions fail. No one involved in investment can afford to ignore the implications of these events, least of all trustees of pension schemes. Most people involved with pensions would agree that the customary separation of the investment management and safekeeping of assets functions of scheme investment is a sensible risk control measure, but are trustees actually aware of the nature of custody risk, i.e. what would happen if the custodian or another entity looking after scheme assets went bust?

There is no duty under Irish law specifically requiring the trustees of Irish pension schemes to appoint custodians. There is, however, a general trust law duty on trustees to keep scheme assets secure, and to guard against the possibility that scheme assets fall under the control of unauthorised persons. It is consistent with this duty that the trustees of larger defined benefit schemes which have segregated asset portfolios will, assuming that their trust deed and rules so allow, usually appoint a custodian to act upon instructions of the investment manager appointed by the trustees.

Apart from the duty to keep assets secure, trustees are under further duties in relation to the selection and ongoing supervision of custodians. Understanding custody risk and taking prudent measures to limit the risk are key parts of being able to meet these duties.

Evaluating custody risk is primarily about understanding the nature of the custody arrangements and the network of entities that may be involved in safeguarding the scheme's assets. In this article, we have assumed that the custodian is located in Ireland.

First, who appoints the custodian? It is quite common for the custodian to be an affiliate of the investment manager and to be appointed by the investment manager under the terms of the investment management agreement. A small minority of schemes take the arguably less risky but costlier approach of having an independent custodian appointed directly by the trustees under a separate agreement.

Second, who actually safeguards the assets? The Irish custodian is most likely to be a global custodian in that it offers custody in a range of international markets through the use of a network of sub-custodians which it appoints. These sub-custodians may or may not be affiliates of the global custodian. These sub-custodians are entities providing custody services in the markets in which the scheme's assets are invested and which are therefore subject to their own local laws and requirements as well as the terms of the contract they have with the global custodian. It is important for trustees to understand that, unless the scheme's assets are invested in Ireland, it is highly unlikely that the Irish custodian is actually holding any assets at all. Custody risk for our purposes therefore exists at essentially two levels, the level of the custodian and the sub-custodian level.

Global custodian

There is some doubt over the nature of the relationship between trustees and custodians, although in our view it is likely that the relationship would be construed by an Irish court as being of a fiduciary nature. What this means in practice is that the custodian from a common law perspective owes special duties to the trustees, such as a duty not to receive profits at the expense of the trustees (unless explicitly authorised), and duties to avoid conflicts of interest between the trustees' interests and those of the custodian and its other clients.

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The nature and extent of the relationship with the custodian will be determined mainly from its agreement with the trustees. The key provisions are those setting out the basis on which scheme assets are held, the terms on which the custodian may delegate its functions and the custodian's liability both for its own acts and those of sub-custodians and other delegates.

When looking at custody risk at this level, it is necessary to consider cash and securities separately as they are held in different ways. The custody agreement will often refer to a "cash account" and a "securities account" to reflect this separation.

Cash

If the global custodian is authorised as a bank, as some Irish custodians are, any cash held with it will usually be held by it on deposit with itself as banker. The trustees' cash is not segregated from the custodian's own assets. Accordingly, the relationship between the trustees and the custodian in respect of cash is one of debtor and creditor. If the custodian becomes insolvent, the trustees will rank as an unsecured creditor along with all other deposit holders. In other words, the cash held by the custodian is regarded as the custodian's own assets and is used to pay its debts to creditors in the statutory order of priorities – only when debts in the first priority have been fully paid can debts in the next priority be paid, and so on. In this order, the unsecured creditors are near the bottom of the pile.

Where Irish custodians are not authorised as banks, you will find that these custodians have placed the cash with a third party which is authorised to take deposits– see below.

Securities

Securities are held differently. The global custodian will typically open a separate securities account for each client and will designate in its books and records that the securities belong to the named client. It is quite common for a global custodian to have a nominee entity which holds securities in its name and as its nominee.

The terms of the custody agreement and the nominee arrangement (if applicable) are very important here because they can help to reinforce the fiduciary relationship between the parties. The custody and, if applicable, the nominee agreement should, to the extent possible in practice, oblige the custodian / nominee to segregate the securities from other securities held by the custodian / nominee and, at the very least, oblige the custodian / nominee's records to state clearly that the assets are held on behalf of the trustees. The agreements should also state clearly that the securities are held in a manner which identifies them as not forming part of the proprietary assets of either the global custodian or the nominee.

The significance of the fiduciary relationship is that, once it is established and accepted that the securities are held by the custodian in a fiduciary capacity, if the custodian becomes insolvent, the trustees should be able to exercise the legal right to trace into the pool of assets held by the custodian to claim the securities held on their behalf. In a situation where the pool comprises assets of other clients of the custodian who also have a fiduciary relationship with the custodian, any such claim will rank equally with such other clients but ahead of claims of clients who do not have the same relationship. The segregation of assets away from the custodian's own assets and those of its other clients is also important in order to preserve the identity of the assets as client assets and so that they do not form part of the assets of the custodian in an insolvency situation.

Assuming their respective agreements include the type of provisions referred to above and provided that the custodian and the nominee entity have each complied with their respective obligations under the agreements, it should be sufficiently clear on the insolvency of the global custodian that the securities belong to the trustees. The existence of a fiduciary relationship (as described above) would also assist the trustees to trace into a pool of assets held by the nominee on behalf of the global custodian and to claim securities held on the trustees' behalf. Clearly, when assessing custodian risk, the trustees need to be satisfied with the record keeping procedures of the custodian. The trustees should also ensure that the custodian makes its records available for inspection so that the trustees can comply with their duties in relation to safeguarding scheme assets and monitoring the custodian.

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Sub-custodian

As mentioned above, trustees may find that scheme assets are not actually held by the global custodian at all but by a network of sub-custodians.

Cash passed to a sub-custodian which is a bank may be held through an account which the global custodian has opened with the sub-custodian on behalf of its clients. Where that entity is insolvent, the global custodian will rank along side all other deposit holders and will get whatever cash is left to distribute among its clients.

In the case of securities, typically the global custodian will have an omnibus account at its sub-custodian through which all of the assets of its clients held with this sub-custodian are held. The sub-custodian will not look through the omnibus account. It is therefore vital that proper books and records are maintained not only by the global custodian, but also at the sub-custodian level, so that in the event of insolvency at the sub-custodian level, there is clear evidence of the

trustees' ownership of the assets of the scheme wherever they may be held.

The trustees' agreement with the global custodian should, at a minimum, impose obligations on the global custodian to take due care in selecting sub-custodians and to monitor their suitability on an ongoing basis and to ensure that the sub-custodian at all times maintain proper books and records and that those records clearly indicate that the cash and securities assets it holds are client assets. Trustees should be aware that even where accurate records are kept, the level of protection given to the trustees will depend on the local laws on insolvency of the country in which the sub-custodian is located.

Given that a change of custodian can be complicated and costly, there is a balance to be struck between maintaining the status quo and changing custodians very frequently. Reviewing custodians every two to three years would seem prudent.

How to manage the risks?

It should be remembered that custody risk cannot be entirely eliminated, but there are sensible steps that can be taken to reduce it. Useful guidance is to be found in the Irish Association of Pension Funds booklet "Guide to Custody".

An obvious starting point is to ensure that the custodian is financially sound. Advice from investment consultants on how to assess this should be sought. The trustees should also look at the custodian's systems and procedures, particularly as they relate to accounting for and identifying the scheme's assets.

Trustees, ideally, will get their legal advisers to review investment management and custody agreements. Managers and custodians usually use their own standard agreements drafted by their own legal advisers that reflect the interests of the manager or custodian in priority to the interests of the trustees. In addition, as Irish custodians can be authorised and regulated pursuant to a number of different legislative and regulatory requirements depending on what other services they provide, their regulatory obligations in respect of client assets can also vary accordingly. It is therefore worth seeking clarification from the custodian as to their regulatory status and more specific legal advice on the applicable client asset requirements and the implications for the scheme.

There is usually some room to negotiate the important provisions of custody agreements even if a custodian asserts that its standard agreement simply reflects market practice. Whether a custodian would be prepared to go so far as to confirm in its agreement that it holds assets on trust (this helps to clearly establish the fiduciary relationship mentioned above), and / or give an indemnity in respect of loss caused by the insolvency of nominees and sub-custodians, is likely to depend on the importance of the trustees' business to the custodian. It is, however, sensible for trustees to start by seeking such provisions.

Trustees should review their custodians every so often. Given that a change of custodian can be complicated and costly, there is a balance to be struck between maintaining the status quo and changing custodians very frequently. Reviewing custodians every two to three years would seem prudent.

Trustees might also decide to use various events as triggers to monitor their custodians more closely. For example, an adverse change in credit rating, a dramatic fall in share price, news of material litigation or the disposal or acquisition of the custodian might be such events.

If trustees consider there is a risk of insolvency at the global custodian level, they may want to take action quickly. Most at risk is cash held by the custodian. The trustees may also want to cancel any contractual settlements that have not been implemented. Usually, the risk in relation to securities is less than the risk in relation to cash. Even where securities may be protected, as the recent experience with Lehman has shown, it could take several years for the trustees to take back possession of those securities if the custodian becomes insolvent.

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