



# GUARDIAN OF ASSETS

Custodians are the backbone of asset protection, operational efficiency, and risk mitigation. But as the macroeconomic landscape shifts and rapid consolidation occurs, these guardians of assets must pivot to meet the changing needs of clients. **Cassandra Baldini** writes.





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In the world of financial services, custodians have long been the unsung heroes who from behind the scenes are entrusted with the crucial task of safeguarding assets. Images of steel vaults, twisted and slammed shut, buried in the basement or the strongroom of heavily guarded institutions spring to mind.

However, a rapidly evolving landscape has transcended the sector's conventional responsibilities and seen it emerge as an innovator, driving change in the industry and, with \$4.3 trillion in assets under custody in Australia alone as at December 2022 end, it's not surprising.

### Up the value chain

"Previously custodians were very much in the back office, simply focusing on the safekeeping of assets," says State Street Australia country head Tim Helyar<sup>01</sup>.

"Front and middle office capabilities would be handled in-house by the asset manager and asset owner, but we're moving up the value chain into the front office."

Looking back, he recalls a time when portfolio managers were very protective of their front office technology as well as front and middle office operations.

"Those capabilities had to be somewhere that you could see, touch and feel," he says.

BNP Paribas head of securities services Australia and New Zealand Daniel Cheever<sup>02</sup> calls this "a natural extension of traditional services."

Cheever said the shift enables the firm to establish a fully integrated end-to-end operating model.

"We create a compelling value proposition for clients by partnering with global front office providers to build solutions that benefit from scale and greater efficiency," he explains.

Meanwhile, Mercer Sentinel Pacific head Tricia Nguyen<sup>03</sup> says, other than building specialised capabilities in-house where possible, it's not uncommon for master custodians to have an arrangement in place with specialist providers.

"For example, registry services for their clients to be able to access more specialised offerings and capability," she says.

"This makes sense so long as there is a clear role for the master custodian in that value chain, for example, a centralised contractual engagement with the specialist provider to streamline

the management of outsourced relationships for the client."

The needs of super funds have evolved significantly over time, and they're increasingly looking for more of a strategic partnership with their custodian.

"The custodian's traditional back-office servicing role, be it asset protection, settling trades, delivering pricing and analytics and reporting has become a hygiene factor," she comments.

For superannuation funds, as internal investment capabilities within the sector grow, master custodians are pivoting.

"Custodians are increasingly building out their suite of products and services outside of the traditional asset servicing and fund administration domains," AustralianSuper chief operations officer Peter Curtis<sup>04</sup> says.

"Custodians are now focused on providing timely, accurate and customisable data sets to support the front, middle and back office."

Further, cost pressures and advancements in technology, particularly in the last five years, have catapulted the sector into a new era.

"... there is now just a lot more comfortability in passing certain capabilities onto the custodian," Helyar says.

And clients are keeping a keener eye on global markets, with many looking to the prevailing conditions of stubborn core inflation and weaker economic growth to inform their expectations and set their tactical investment strategies.

"We feel that the challenge for our clients is to manage investment returns through a period of low conviction," Cheever says.

Another development to come from the change in environment is clients choosing to outsource business once kept in-house as interest rates rise.

Despite the plethora of new services to offer, and of clients looking to offload functions, cost pressures persist – and they have an impact on client demands, Northern Trust head of Australia and New Zealand Leon Stavrou<sup>05</sup> says.

"The consistent issue on the minds of our clients is cost and managing those costs," he says.

"Ensuring efficiencies with budgets and operating models, as well as looking for ways to use their assets effectively and leaning on their third-party providers to understand how we can help."

Stavrou explains Northern Trust would typi-



*Custodians are increasingly building out their suite of products and services outside of the traditional asset servicing and fund administration domains.*

Peter Curtis

cally look at something like securities lending to combat cost pressures.

"Clients view securities lending capabilities in two dimensions," he says.

"Firstly, is it a revenue generating play or is it something from an operational perspective that they're able to use to pay for some of their operational costs?"

Of course, savings are of great importance to Australia's increasingly competitive superannuation sector as funds look to pass on cost benefits to members. When it comes to tendering for a custodian, super funds are pressured to find synergies within operations, and those pressures are then passed onto the custodian.

"Super funds keep us honest and make sure that we are pricing their business in the most scalable and effective way," he says.

Putting the price of asset management to one side, Helyar points out the two main external costs when it comes to engaging a custodian.

"That will be the customer custodial bill, as well as the member administration bill," he notes.

One obvious way to pass on the cost benefit to clients is through scale, he adds.

"That's where we get the benefit of being a global player with many clients across multiple jurisdictions," comments Helyar.

"If we can build that scale, we're expected to be able to pass on that benefit."

Aware Super head of investment services Michael Nairn<sup>06</sup> agrees that scale is important.

"With super, given the use of a single custodian, the size of the relationship can bring benefits of scale, which is also important to us as we work to deliver strong long-term returns and lower the cost to serve our 1.1 million members," he says.

When engaging a custodian, Nairn says Aware Super looks for "holistic custody" and administration services that consider the whole of the fund rather than just specific service elements.

However, a changing landscape, market consolidation and the size and scale of super funds across Australia are forcing the evolution of custodians further still.

### A changing landscape

Consolidation within financial services is occurring across the board. But homing in on the super sector, Helyar says he supports the industry view.

"We believe that there will be a small num-

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# BNP PARIBAS





# The bank for a changing world





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ber of mega-funds, a handful of medium-sized funds and very few boutique funds..." he says.

For several years now, APRA has been placing pressure on funds with less than \$30 billion in funds under management to merge.

At the same time, KPMG predicts that both AustralianSuper and Australian Retirement Trust could boast more than \$1 trillion in FUM each within the next 20 years.

Still, Helyar believes that super funds with between \$30 to \$50 billion can survive.

"A lot of people forget that 10 years ago the biggest funds had around \$50 billion FUM," he explains.

"Consolidation and that scale game will continue, but it's important for us and it's important for all custodians to be able to service clients, no matter how big or how small; they're all very different relationships."

J.P. Morgan's *Future of Superannuation* report suggests there will be fewer than 75 funds by 2025.

Since the report was released in 2022, there has been a significant number of merger activity across Australia, says J.P. Morgan head of securities services Australia and New Zealand Nadia Schiavon<sup>07</sup>.

"There were 174 funds in March 2022 compared to around 120 now. Of the 120 funds, interestingly, 30 funds represent 90% of the market," Schiavon comments.

Due to the unprecedented level of consolidation, custodians must also have expertise in transitions. Otherwise, it's a huge risk.

"For those funds on the merger path, a key capability in an asset servicing partner is experience and dedicated expertise in transitions," she says.

J.P. Morgan certainly can speak to scale, with over \$1 trillion in total assets under custody in Australia alone.

Due to this scale, J.P. Morgan has a separate team solely focused on managing transaction activity and ensuring a seamless operational experience.

"We have developed a well-rehearsed playbook with subject matter expertise to support and partner with our clients through this activity," she says.

"Our most important role is to keep the transition moving and take care of the operational burden to make it as seamless as possible."

Nguyen agrees with the sentiment.

"As super fund consolidation continues, the remaining funds have broader and more complex requirements," she says.

"We expect this will drive a greater need for their custodian to better understand the fund's business model and drivers for growth."

Stavrou says being able to provide support through consolidation is "the new norm", applicable to all manner of clients.

"It really isn't just super funds because asset managers are also acquiring each other," he points out.

"Either way, what this means is you're always having to support that type of activity. It's al-

most become business as usual for us (BAU), but it's not BAU for the client."

There are two ways to support clients through consolidation, he adds.

"That's both from an onboarding and offboarding perspective," Stavrou says.

"We've seen a number of instances where there has been a merger and we are the ones that are supporting the offboarding. But that's still managed through a positive relationship and engagement."

The Australian Custodial Services Association (ACSA) reviews statistics which demonstrate the ongoing impacts of the mergers of asset managers and superannuation funds.

"Consolidation in the Australian custody industry is leading to the further concentration of the total assets under custody across a smaller number of providers," ACSA chief executive David Travers<sup>08</sup> says.

However, Travers makes the point that consolidation creates opportunities for those left in the game, such as increasing the size of their books to drive improved business outcomes and sustainability.

"It also represents an opportunity for smaller providers to evolve their books as they find growth opportunities," he adds.

Ultimately, Travers says consolidation leaves the Australian custody and investment services industry in a very competitive position. So competitive in fact, that in recent years it's led to some, including once dominant players, opting to exit the sector.

Last November, NAB confirmed it had decided to wind down its asset servicing division following years of mandate losses and failed sale discussions.

The exit will see Australia's last domestic custodian depart the space with the closure on track to be completed in 2025, NAB executive asset servicing transition David Knights confirmed.

As part of an agreement, NAB is referring some of its clients to its own global custodian Citigroup (Citi).

The two have partnered since 2016 and NAB explained that under the agreement its Australian custody client base will be given the option to transition their arrangements.

Citi was also a beneficiary of RBC's decision to pull out of Australia, with the former acquiring the local RBC Investor & Treasury Services business in early 2020. Citi head of custody and fund services sales in Asia Pacific Mark England<sup>09</sup> explains transitioning a client from one custodian administrator to another can be an extremely complex task.

"... one that brings with it a great deal of responsibility, focus and some risk," he says.

In saying that, England adds, a higher than normal volume of investors moving across to new providers in a short period of time will be a feature of the Australian landscape for the next couple of years.

"We have seen this play out in a lot of different

markets. Again, the number of global custodians has diminished quite substantially," he explains.

"So, in short, I hope that we have more opportunity than we had because we have one less competitor."

In Helyar's view, the custodians that have chosen to exit in recent times share some similarities.

"I think the commonality between the two exits is really the investment required to stay relevant and to stay at the forefront of this market. There's a lot of work going on at the moment in the industry, upgrading platforms, transitioning to new platforms, and that is expensive," he says.

"To pull that level of investment off you need scale and the ability to continue investing through the cycle."

And as some players exit, others – like BNP Paribas – remain focused on the market.

"We remain very committed to the Australian marketplace, as others have exited. We see a natural opportunity with NAB Asset Servicing exiting the market; we're very excited about the opportunities that might bring," Cheever says.



*We see a natural opportunity with NAB exiting the market; we're very excited about the opportunities that might bring, and we continue to support.*

**Daniel Cheever**

## Technology is key

Naturally, technology and innovation go hand in hand. In fact, one would be all but impossible without the other.

J.P. Morgan invests a cool US\$14 billion into technology annually, Schiavon points out.

"Our capital strength and scale allow us to continually reinvest in products and services to support current and future strategic investment and service needs," she says.

"We are able to leverage tools such as robotics, machine learning, blockchain and APIs to streamline our core operating model to provide more accurate, relevant, timely, reliable and secure data."

Schiavon says data management is a key strategic focus for clients.

"At J.P. Morgan, we've established a dedicated data solutions business within securities services led by industry experts, and through J.P. Morgan Fusion," she explains.

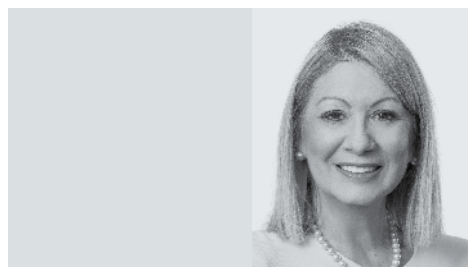
The platform delivers end-to-end data management and reporting solutions for institutional investors.

"We are developing a differentiated cloud-native platform to help clients manage and leverage their data in a scalable and efficient way," she explains.

The growing size and complexity of portfolios is also placing new importance on getting quality data to reveal investment insights and manage risk. As such, J.P. Morgan recently appointed its former global head of securities services Teresa Heitsenrether to the newly created role of chief data and analytics officer.

"This highlights the critical importance that data and artificial intelligence (AI) is to J.P. Morgan's future success," Schiavon says.

Meanwhile, Northern Trust uses a technology called Snowflake to support its data warehouse solutions, State Street leverages Charles



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River Development, and BNP Paribas works with BlackRock's software Aladdin.

"We continue to invest in best-of-breed solutions that enable our clients to have both access to the functionality they require and the information they need to be better investors and fiduciaries," Cheever says.

"We've supported both asset managers and asset owner clients to implement Aladdin as their front office platform."

He says programs such as Aladdin help the firm to support even the largest of super funds.

"It's one of the premier front office systems in the market and we certainly feel that the best way for us to support customers is to be highly integrated with platforms like Aladdin," he says.

With data becoming a key differentiator, ACSA is also developing digital initiatives in this space.

"We recently launched our fund tax data standard in collaboration with the Financial Services Council," Travers says.

The data standard enables an operating environment where fund tax data elements are digitally exchanged and can be interpreted without ambiguity, driving greater integrity, timeliness, and consistency of tax data for distributions, withholding taxes, annual tax statements and regulatory reporting obligations.

It's also developing a unit price data standard.

This trend of the custody industry building its own solutions is being seen at the individual custodian level too. For example, Northern Trust is partnering with fintech firms to drive in-house capabilities.

"We're not necessarily in the business to build everything ourselves," Stavrou comments.

"We want to partner where it makes sense and find new ways to bring solutions to our clients that make our services quick, seamless and efficient for them."

Helyar points out the other motivation driving technology - returns.

"Being able to provide that end-to-end portfolio management capability gives a fund as well as asset managers, frankly, the ability to manage their own portfolios and do that with one service provider," he says.

"So, [it's about] being able to offer that true end-to-end for clients with one partner and being able to assist them to do what they're good at and that is managing pools of money and seeking returns."

Another reason why data has become so important to custodians and their clients is because of the role that it plays in ensuring objectives can be met, particularly ESG goals.

"All of our business' objectives align to ESG principles, with securities services offering ESG data and analytics. Our Manaos platform is helping clients and we will continue to roll out ESG solutions for both analytics and compliance," Cheever says.

He explains the firm uses compliance tools that help clients assess their portfolios against factors such as carbon footprint.

"In the custody and clearing space, local custody remains an important segment for BNP Paribas, and we've been able to increase our market share for the local custody business as other competitors have exited this segment," he explains.

### Digital asset capabilities

For about a decade now, the financial services industry has been wrestling over whether cryptocurrency and other digital assets should be taken seriously.

Digital assets are an area of great potential for custodians; a report from Northern Trust and HSBC this year predicted that 5%-10% of all assets will be tokenised by 2030.

Travers says the emergence of cryptocurrencies and digital assets into mainstream investments will impact the current services of custodians. For some, it already has.

"It is expected that traditional assets like shares, bonds, managed funds etc. will also evolve to use new technologies, such as distributed ledgers, for efficiency and ultimately become best practice," he says.

"ACSA members are already turning their minds to what this will mean to business models and services."

Where Northern Trust most sees demand is from hedge funds, particularly looking to invest in cryptocurrencies, and so offers support from a custody perspective and a fund administration perspective, Stavrou explains.

Meanwhile, J.P. Morgan currently supports certain activities, including flat cash management for crypto exchanges, and creating structured products with exposure to crypto indices.

"But we do not directly touch cryptocurrencies," Schiavon says.

Meanwhile, Helyar says interest has peaked and fallen in Australia.

"I think we saw a wave of interest, probably two years ago, but recently there has been the much talked about crypto winter and freeze," he says.

"We haven't seen a lot of institutional interest in those investments. But I think, over time, the next wave will be a little different and will depend on how it's regulated."

Indeed, regulation is tricky when dealing with a distinct lack of transparency.

"We're watching that evolution, but it's not really a near-time priority for our custody business," England comments.

Having said that, Citi is still intrigued by the potential of blockchain technology, with several initiatives on the boil.

England explains the use of blockchain to create digital versions of assets has significant potential to improve efficiency, create new business models and in some cases improve distribution and liquidity.

"We are working on developing custody capabilities for digital assets and our focus is on digital bonds regulated financial market infrastructure," he explains.

"Citi, like many others, is curious about the viable use of that technology. There is a demand from clients to understand how we improve efficiencies, create new business models and how we better improve clarity."

### Guardians of governance

All in all, the role of a custodian could not be more important, and this importance has never been more obvious than in recent months when we saw the downfall of several banks in the US and in parts of Europe. A significant uptick in cybersecurity threats, like recent hacks that stole the data of US pension fund members and even that of our own NGS Super, also calls for a strengthening of systems and processes to ensure operational risks are effectively managed at all times.

"[An institution like Citi] has regulatory obligations in a number of different jurisdictions. Fundamental to that is understanding who our clients are regulated by and what their obligations are to their regulators, so we can ensure we allow them to meet those obligations while meeting the obligations of our own regulators," England says.

Such regulation is "a huge domain", requiring Citi to maintain a great deal of internal infrastructure to ensure it's "behaving appropriately."

"There are annual audits, a great deal of reporting, a great deal of bank-wide internal oversight as to the mechanisms that we have in place as a business, to adequately manage and measure our risk," England explains.

Governance structures are particularly important for super funds to also ensure issues like unit pricing errors are avoided, mounting pressure on both funds and their custodians to uphold processes for members' best interests.

"It's important that funds build relationships with their custodian as this enables a deep understanding of each other's needs and capabilities," Curtis explains.

"Periodic formal operational due diligence sessions, in all locations a custodian provides operational service, also play a key governance and oversight role."

Meantime, AustralianSuper's service providers are governed in line with its third-party framework, which includes oversight and assurance activities like periodic operational risk due diligence and reviewing the custodian's annual policy updates.

"A robust engagement and governance framework for ongoing monitoring of the custodian helps to ensure that all issues can be identified, escalated and managed to resolution in a timely and efficient manner," Nguyen explains.

With this in place, custodians are better equipped to carry out their role of safety net for financial institutions. And while the landscape is shifting, traditional roles will remain at the heart of custodial processes.

"The role of a custodian may have evolved over time, but assisting clients to navigate the complex regulatory environment will always remain a key focus," Cheever concludes. **FS**



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**Leon Stavrou**