FCA plans review of custody banks' operational resilience

May 2017

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Abstract

On 18 April, the Financial Conduct Authority ('FCA') released their 2017/18 Business Plan[1] describing their planned work for the coming year.

Amongst their priorities relating to retail customers, technology and Anti-Money Laundering ('AML') was an announcement from the FCA of planned supervisory interventions in the custodian banking sector:

"Custody banks provide critical support services to the funds industry and trading activities, which require them to be accurate, secure and resilient. We are planning a number of interventions in this sector[2]."

Moving beyond enforcement of Client Asset Sourcebook ('CASS') rules, the FCA intends to evaluate ***operational resilience***, as they are concerned with the risk that custodian banks, in their capacity of providers of ***critical services*** to the investment management sector, "***may not be able to meet current service standards or ensure continuity of service***."

This sign posting from the regulator highlights a number of areas where management at banks in the custody and asset servicing market should focus their attention to anticipate this regulatory scrutiny and be in a strong position to respond.

Operational resilience of custodian banks in the spotlight

Global custodians with operations in the UK are used to dealing the Prudential Regulation Authority ('PRA') whose focus on resilience of the sector is well established given the sector's role in the provision of critical services and consequent importance to financial stability. But also, because of custodians' profound impact on the smooth running of financial markets including retail customers through the investment funds industry, the Financial Conduct Authority ('FCA') has a prominent role to play in promoting competition and enhancing market integrity.

In this capacity, the FCA highlights the following risk:

"Providers of critical services to the sector, including custody banks, may not be able to meet current service standards or ensure continuity of service."

After high profile interventions regarding CASS, the FCA is now looking to evaluate global custodians as critical market infrastructures, and will:

"[...] support the PRA's work to map and evaluate critical infrastructures in firms, we will evaluate custody banks' resilience and resistance to cyber-attacks, and we will evaluate the quality of product governance and controls at firms."

The outcome sought from these regulatory "interventions" with custodian banks is to ensure that:

"[c]ritical service providers, particularly custody banks, achieve acceptable levels of operational resilience."

Custodians banks as a potential vulnerability

The FCA has identified global custodians as being a potential vulnerability in the financial system, having insufficient operational resilience due to perceived underinvestment in IT systems. This may be galling to those global custodians who budget significant

[1] *https://www.fca.org.uk/publication/business-plans/business-plan-2017-18.pdf.*

[2] *Emphasis on "We are planning a number of interventions in this sector" is Avantage Reply's.*

investment amounts each year in developing and updating their technology platforms.

The FCA's decisions have come from their multi-year study on the asset management market, from which an interim report was published last November.

A number of observations were made regarding the provision of custodian bank services, including high concentration in the provision of transfer agency and custody services. Some asset managers highlighted a consequent vulnerability to IT issues or other sources of potential failure of or disruption to these custodian banks.

The bundling of services such as custody, depositary and fund accounting services was discussed as a potential impediment to asset managers being able to "shop around", although the synergies gained in providing these services was recognised by the FCA.

Asset management study

As a part of this study, the FCA has identified potential issues with the process by which asset managers procure custody services. They cite the infrequent changing of providers (sometimes less than once a decade) as an impediment to obtaining services at an appropriate level of price or quality. Overall, the FCA has stated that they are:

"***...concerned about contractual terms between custody banks and investment managers and there is evidence that terms are more beneficial for the banks.***"

The FCA notes the concentrated nature of the UK custody market, estimating that the top three custody banks hold 55% of Assets under Custody ('AuC') in the UK, with the top seven holding an estimated 85%. In particular, transfer agency ('TA') is seen as particularly concentrated with the top transfer agent having communicated to the FCA that they estimate their share of the UK market as being 65%.

Barriers to entry were identified, including the scale required to do business, a requirement for a global presence from many clients and the necessary investment in IT infrastructure.

On the topic of IT investment, the FCA notes that historically low profit margins in custody businesses has constrained significant investment in technology upgrades. This of course would give rise to prudential and operational risks that would materialise in the event of service outage – something that many custody banks envisage in their reverse stress tests and recovery plans.

Indeed when the PRA look at recovery and resolution for custody businesses, there is a huge focus on operational continuity of this so called 'critical economic function' in times of stress, given the importance of this to financial stability.

What intervention is planned?

Given these conclusions, the FCA's supervisory attention will be directed at:

- **Operational resilience;**
- **Resistance to cyber-attacks;**
- **Internal controls;**
- **Critical infrastructures (in coordination with the PRA);**
- **Product governance; and**
- **CASS (client asset segregation).**

These are of course, wide reaching and complex topics that go to the heart of custody banks' operations and risk management activities. Cyber-security, for instance, is often cited as the number one operational risk amongst banks in the current environment and that focus continues to intensify as events occur which remind everyone that this is still a very real and present threat.

What are custody banks advised to do?

Little detail is offered on the timing or nature of actions planned, but that should not stop management from taking some proactive steps.

The FCA's list of focus areas above will not have come as a surprise to those charged with managing risk and governance within custody businesses. Indeed there is much overlap with the list of top risks within these institutions. But anticipating and preparing for regulatory scrutiny is another thing.

This requires being prepared, transparent and forward thinking.

1) Being on the front foot through critical self- assessment

In anticipation of any form of external challenge, it always pays to conduct robust internal challenge first. Custody banks should already be examining their risk and internal control frameworks addressing all key risk types from financial through to operational; understanding vulnerabilities in their business processes and supporting IT infrastructure; and performing a systematic and robust programme of self-assessment and gap analysis against both regulatory expectations and peer practice.

Well-established practices designed to ascertain banks' resilience to adverse external and internal events should be re-examined to ensure they really put these regulator-identified high-risk areas under sufficiently rigorous tests. This includes stress testing, recovery planning as well as capital planning processes (including ICAAP) – all of which have an increasingly important operational risk element to them.

2) Building trust through openness and transparency

Identifying, documenting and communicating the weaknesses or threats identified through a self-assessment programme – both internally and in regulatory dialogue – is key to building trust and moving forward with remediation and enhancement.

By the same token, notwithstanding the risks identified by the FCA, custody banks have are still reasonably confident in the stability of their platforms that have served customers over the long periods that the FCA highlights. So not only does it pay to be honest and constructive about soft spots in internal processes, there also needs to be precise and specific articulation of the basis for management's comfort in their processes.

3) Effective remediation and enhancement planning

Based on a gap analysis and clarity on strengths and weaknesses in the areas subject to regulatory scrutiny, banks can refine their existing programmes (technology, operational, risk, etc.) and design and prioritise new change requirements. In an environment of persistent cost cutting pressures and resource constraints, and intensifying pressure to invest in technology just to keep up with growing competition, prioritisation and focus on high-risk areas is crucial.

How can we help?

We have an established track record of providing risk management consultancy services to a number of custodian banks, including four of the five largest global custodians (by assets under custody). Avantage Reply also provides advisory services to Clearing Houses, Exchanges, specialist providers of custody services and other providers of critical services to the asset management and capital markets sector.

We have worked with our clients to improve and demonstrate operational resilience in these institutions, on behalf of senior management, regulators and internal audit, and are well placed to support banks in facing future challenges with regulatory or business-driven change.

About Avantage Reply

Avantage Reply (a member of the Reply Group: www.reply.com) is a pan-European specialised management consultancy delivering change initiatives in Risk, Compliance, Finance (Treasury, Capital Management and Regulatory Reporting), and Operations within the Financial Services industry.

Within our core competencies, we have extensive experience in implementing changes driven by:

- Industry-wide legislative and regulatory initiatives (across prudential and conduct regulation);
- Business improvement and optimisation agendas (e.g. risk appetite and capital allocation); and
- Mergers, Acquisitions & Divestments (e.g. business combination, separation and flotation).

We are available to discuss in more detail the impact of the FCA's planned supervisory focus on your organisation.

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