The Future of Custody and Depository Services

A Platforms-first Operating Model to Enable Digital Transformation at Speed and Scale

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Contents

Introduction

The global custody market was valued at US$24 billion in 2020, growing at a healthy rate of 8% over the last 12-18 months. The market is highly concentrated, with the top 15 custodians holding more than 70% of the total assets under custody. M&As have been a popular method to gain market share or generate economies of scale as price competition escalates. However, in the last few years, traditional financial products, such as the low-cost, index-oriented Exchange Traded Funds (ETFs), have created several operational challenges for custodians and depositors. ETFs attracted US$659 billion of inflows in the first six months of 2021, compared with a record-breaking US$767 billion in 2020. Further, large custodians wrestle with the high cost of management services for funds, as volumes rise with a decline in commissions.

Margin compression continues to place pressure across the custody services industry, with distributors, asset servicing specialists, and infrastructure entities all forced to review their business models in the face of profitability contraction. Core custodial processes, such as asset servicing, corporate actions, and settlements, are also marred by operational inefficiencies. Hence, custodians need to invest in automation and process simplification to cut these operational overheads. Process simplification is also important as custodians share attributes with Central Securities Depositories (CSDs) and act as an interface between investors, buy-side firms, and CSDs. They are, thus, guardians of high-volume customer data. Custodian banks are also envisioning how they could help their buy-side clients make better use of this data.

Global custodians need to consolidate, analyze, and report on significant amounts of data, while adapting to rapidly evolving regulations, such as Know Your Customer (KYC) being extended to Know Your Distributors (KYD). Similarly, investor demand for value-added services has put pressure on custodians and depositors to offer extended middle-office services, beyond trade capture, safekeeping, and recording of marketable assets. Custodians also face competition from FinTechs and technology providers, which offer diverse services such as fund administration, collateral management, and digital custody.

At the same time, there is a pressing need for the industry to orchestrate the safekeeping of digital assets, whose valuations have been rising exponentially. This growth is evident from the cryptocurrency market's value shooting up from US$578 billion in Q4 2020 to US$1.85 trillion in Q3 2021 due to increased traction in retail investment across digital assets. Diverse financial institutions are working to offer investors the ability to securely store, buy, and sell digital assets. But for digital asset trading to really take off, institutional investors need to be assured that they are safe. This means that the future envisioned by these financial institutions should rest on a digital asset custody foundation to offer fast, secure, and seamless experiences. Increasingly, custodians are investing in platforms that will help them manage both traditional and digital assets. These custodial services require specialized platforms that combine security with speed, scalability, and operational flexibility. Because these services encourage higher asset investment, digital custody offerings are vital for the continuing expansion of various assets. In this research, we describe the benefits of a platforms-based approach for custodians and depositors and recommend the way forward to implement it.

Evolving priorities for custody and depository services and potential challenges with the current model

The top priorities for global custodians as they seek to improve their business performance metrics are to gain operational efficiencies, shift to digital-oriented business models, align with a rapidly evolving regulatory environment, and monetize data, as depicted in Exhibit 1. Depositors and custodians are increasingly reducing their reliance on high-volume manual processing to improve margins. Increased competition from FinTechs and uncertain macroeconomic factors have further created margin pressures for these firms.

For instance, custodians in the US are subject to federal laws governed by the Office of the Comptroller of the Currency (OCC), state laws, and laws of foreign countries in which they offer services. This creates complex regulatory dynamics for global custodians. Legacy systems further reduce their agility to make systemic changes as regulations change. Thus, global custodians are focusing on specialized services such as credit and collateral review for peer-to-peer lending. Custodians are also investing in UI/UX solutions to provide customizable Custodians have also discovered the potential of data monetization as a revenue stream; however, navigating the data collection world can be a minefield, given custodians' reliance on archaic technology

EXHIBIT 1

Key priorities for custodians and depositors

Source: Everest Group (2021)

Gain operational efficiencies as margins diminish

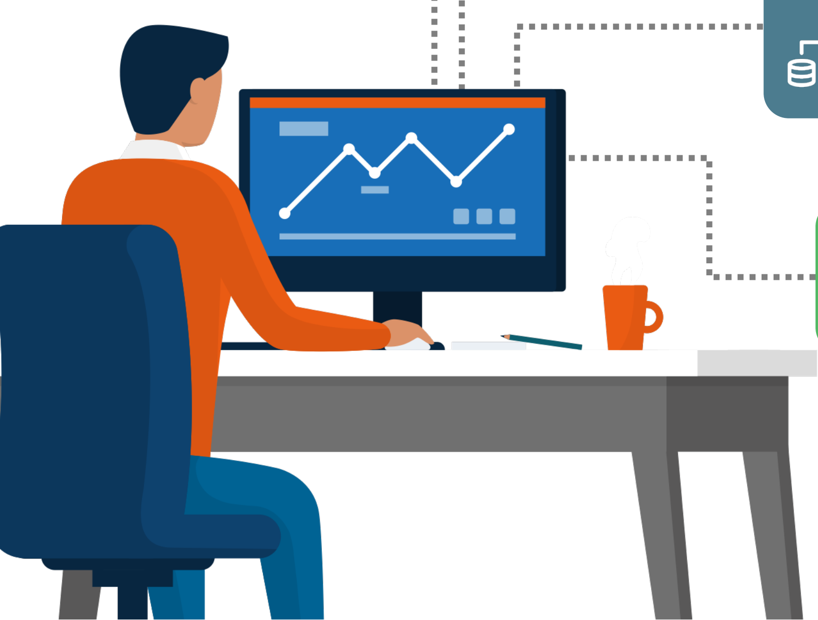
Custodians are aggressively reducing their reliance on manual processes to gain operational efficiencies as costs decline and margins improve.

Adapt to the changing regulatory landscape

Custodians face difficulties in keeping pace with federal laws, which are governed by the Office of the Comptroller of the Currency (OCC), state laws, and laws of foreign countries in which they offer services.

Monetize data at speed and scale

Custodians could evolve as aggregators by consolidating, processing, and monetizing the large volumes of data they have at their disposal.



Shift to digital business models and assets

An exponential rise in the market capitalization of digital assets comprising cryptocurrency and non-fungible tokens adds complexities with respect to tapping into this high-growth market.

The proliferation of digital assets among institutional investors is driving custodians to invest in modern technology and operations. This is evident from the increase in the market capitalization of digital assets, comprising cryptocurrency and non-fungible tokens, from US$1.95 trillion in mid-August 2021 to US$2.14 trillion a month later. Recent research from analytics firm S&P Global suggests that 7 in 10 institutional investors expect to invest in or buy digital assets in the next five years. Thus, it has become vital for investors to have a high-grade custodian to safeguard and manage their traditional and digital asset holdings.

While established custodians and asset servicing firms grapple with technology debt in their modernization journeys, FinTechs are seeking to offer investors the ability to securely store, buy, and sell digital assets on digital-native platforms. Ecosystem participants such as Coinbase have spearheaded frameworks and guidelines on digital asset listing throughout the financial services network. Coinbase continues to explore support for new digital assets that meet certain technical standards and has built a Digital Asset Framework (DAF) to assess factors such as security, compliance, and custody in the open finance market. The established market intermediary InterContinental Exchange (ICE) has launched a FinTech, Bakkt, in collaboration with a few strategic investors to explore crypto custody services. Similarly, firms such as Finoa are building safekeeping and custody services for institutional investors and corporations.

These developments point to the need for traditional custodians to improve their operational efficiencies by automating manual and repetitive processes, reimagining settlement operations through Distributed Ledger Technologies (DLTs) for faster and cheaper processing, and monetizing large volumes of data at their disposal.

A platform-led approach as an enabler for a new market structure

As financial markets evolve rapidly with newer asset classes, custodians and depositors could leverage their intermediary position in the value chain to take advantage of these innovative products and service offerings. Custodians need to build operational readiness for assets with high volume transactions (such as ETFs), align product offerings for new types of assets (such as alternative investments, sustainable finance, and cryptocurrency), and review operational structures to provide high-margin value-added offerings.

Traditional custody would need to traverse from a siloed, unstructured, and complex data universe to a single book of records to tap into these opportunities. A platform-led operating model will accelerate this transformation, as investors demand access to a seamless paradigm facilitated by an API-enabled plug-and-play solution. We believe that acting now and acting fast on some of these opportunities will create a future source of higher margin services for custodians.

As custodians adopt a platform-thinking model, they will build systems that are composable and configurable to solve specific buy-side challenges and create hyper-personalized investor experiences. The design philosophy requires aligning the technology, process, and people strategy around client experiences.

A customer-centric approach empowers the custodian with a strong digital foundation that facilitates the transition to a more agile, flexible, scalable, and resilient operating model for seamless scaling of transformation initiatives and high responsiveness to customer needs.

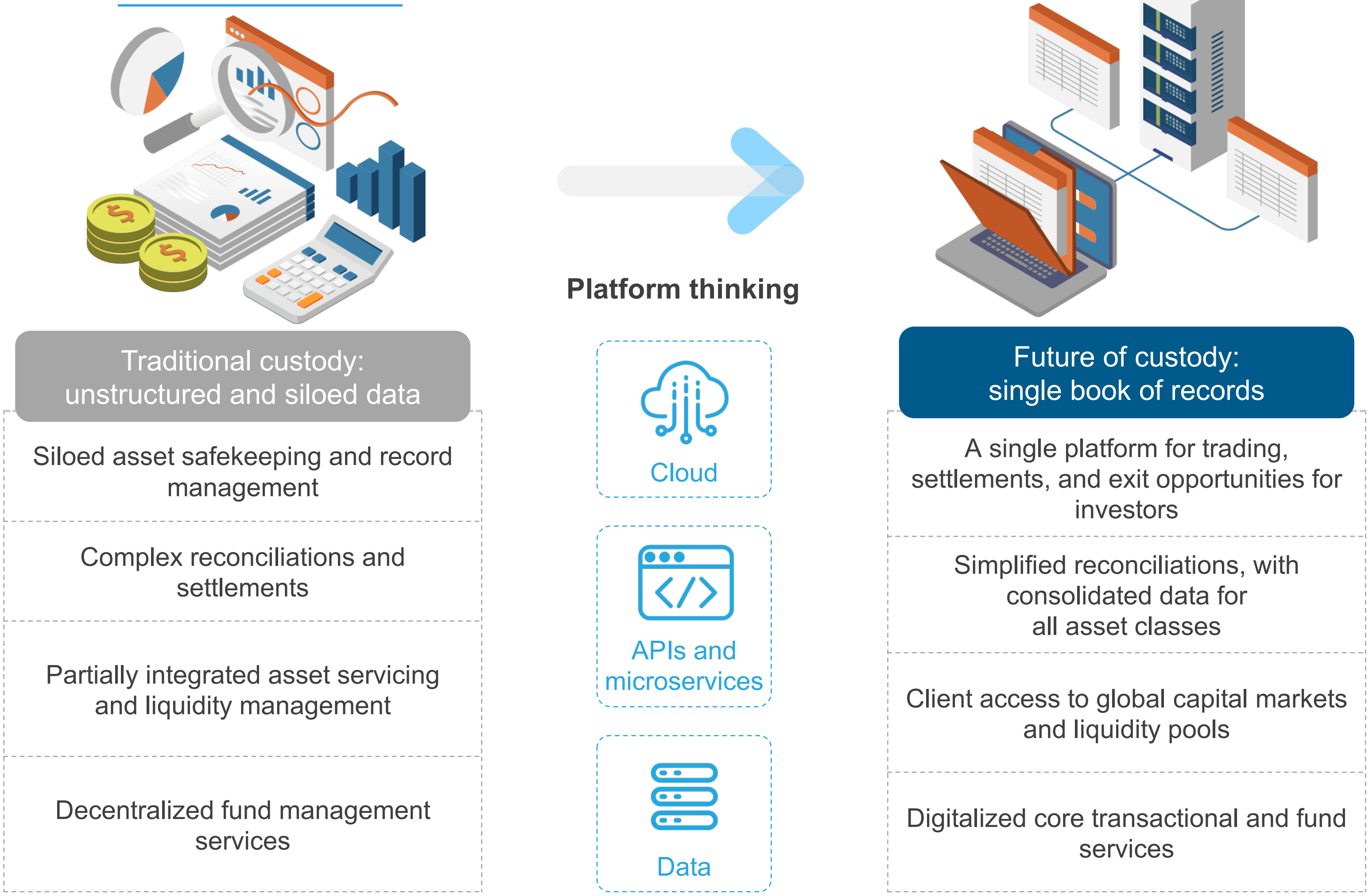
These composable systems will manifest into a “platform of platforms” model, in which complex processes can be seamlessly combined using APIs, microservices, and the cloud as the foundational elements. Complex procedures such as Net Asset Value (NAV) calculations and forecasting and workflows requiring multiple hand-offs, such as corporate actions and collateral management, can be integrated to offer a powerful investor experience. Data and analytics capabilities can be enhanced to extend custodians’ value-added services. For instance, Societe Generale launched D-View, which provides decision support for asset managers via access to dashboards that can be customized per needs and a consolidated view of the funds' distribution data from different markets.

The exhibit below showcases the value chain transformation for custodians when they shift from a traditional custody model to a futuristic, platform-enabled approach.

EXHIBIT 2

Value chain transformation for custodians: shift to a platform-first operating model

Source: Everest Group (2021)



A platform-driven model will also disrupt the value chain by reimagining and revamping several processes. The primary custody responsibilities of settlement and servicing are also expected to change dramatically. Settlement and processing will become commoditized and make low contributions to margins. Specialist providers and utility platforms will provide low-cost options for settlements, thereby reducing the cost per transaction and providing economies of scale through data-driven personalized experiences on a single platform. Specialists can leverage APIs to make their services more attractive to Registered Investment Advisors (RIAs), who will have access to internal data as well as external data, including Society for Worldwide Interbank Financial Telecommunication (SWIFT), Financial Information eXchange (FIX), Single Sign-On (SSO), and Standard Custodial Files (SCF), thereby enhancing the overall investor experience. Similarly, asset servicing will evolve into an orchestrator of solutions and information across investment processes, thereby transforming from a back-office function to a business enabler for asset managers. Asset servicers will leverage a data-driven platform to provide valuable market, investor, and regulatory intelligence. However, to achieve this transformation, investments must bring together modular and flexible analytics-driven solutions that address investor needs and priorities.

Similarly, a blockchain-enabled solution will help simplify processes such as trade reconciliation, corporate actions, and transfer agency. For instance, if funds are transferred between investors and the activity is recorded on a distributed ledger, there will be no need for a transfer agent to record subscriptions and the registry of participants for the fund. Blockchain could also simplify processes and reduce errors for custodians in elective corporate actions. Global custodians share a common interest in reducing the risk of losing money due to operational errors. Custodian banks could use a blockchain network to communicate the details of elective corporate actions, such as rights issues and proxy votes. The current process is manual and hence error-prone, with custodians paying out when an investor loses money because of inadequate or incorrect information. Hence, blockchain could help eliminate losses and, at the same time, enhance investor data security.

Shifting to a platform-based operating model could help custodians and depositors take a phased approach to modernization. In the near term, custodians could leverage data, Application Programming Interfaces (APIs) and microservices, and the cloud to bridge gaps in their operations and experiences as they connect disparate systems. In the long term, the vision is to stitch composable elements that deliver end-to-end operations across multiple investor segments.

The ability to build once and deploy multiple times is the target state for custodians' platform-based operating models. Such a model will have elements of composable architecture and data-driven operations delivered in an as-a-service consumption model. Custodians will, therefore, be able to meet varying investor needs and provide storage and protection for both traditional and digital assets under one umbrella.

This operating model will also drive cloud adoption. Custodians will be able to avoid security challenges by using multi-factor authentication, confidential computing, and powerful encryption for their reconciliation and trade data. Operational processes in the end-to-end investment value chain will experience a data-led transformation.

As money managers demand ancillary services such as tax and estate planning, transaction settlements, account administration, and dividend collection – which go beyond core custody services – there is increasing need for custodians to become one-stop solution shops to cater to these different needs. Therefore, custodians are increasingly moving from traditional siloed operating models to platform-based end-to-end operating models.

Data will become an asset that feeds sales and advisory platforms to generate value-added services for investors. Custodians will evolve into data aggregators, taking information feeds from different sources. We also believe that streamlining middle-office operations with advanced data analytics could ensure higher margin services for custodians. In the past, State Street's acquisition of the front office platform Charles River Development led to the development of a front-to-back investment servicing platform, State Street Alpha. Alpha is supported by a data control framework and deep enterprise data management capabilities that help integrate data from multiple investors and third-party sources. This demonstrates how data aggregation holds the key to the next growth wave for custodians and asset servicers. Global custodians are gradually shifting their focus to data valorization either to improve internal data usage or expose their data and related insights externally, thereby becoming an alternative data provider.

APIs will transform query handling, issuer services, and proxy voting, as investors get easy access through a single window on the investment platform. It will also allow easy integration with other internal and external systems and data sources to ensure a seamless experience throughout the investor journey. Custodians will act as the consolidated data source for all asset classes, including cryptocurrency, digital keys, and digital identities.

EXHIBIT 3

Key technology investments to build the custody of the future

Source: Everest Group (2021)

Simplified reporting and compliance

Open API-led architecture to expose legacy core

In-built data security to meet compliance standards

Microservices-enabled modular architecture

Intuitive reports that show top-level view of risk exposures

Effective data management with data-on-cloud strategy

To build this future of custody and asset servicing, custodians need to make certain key investments, as exhibited below. Data, the cloud, and open architecture will form the backbone of these transformational investments.

A platform-led operating model will, hence, be the bedrock for next-generation technology adoption at speed and scale. This futuristic platform will allow the co-existence of traditional and digital assets and conform to local and global jurisdictions for governance and regulatory purview.

Conclusion

Custodians are seeking a strategic model and redesigning their systems and operations to become future-ready. Changes in regulatory dynamics, lower margins, and the proliferation of complex asset classes are compelling custodians to reinvent their target operating models to serve specific investor needs.

A platform-based approach will help custodians and depositors to unify and simplify existing workflows. It will provide custodians the opportunity to build a compliant-by-design roadmap that ensures configurability in their regulatory reporting and risk monitoring requirements. To achieve these benefits, custodians would need to invest in data operations and management, process reimagination, organizational change, and techno-functional and reg-techno-functional talent to redefine the target operating models to serve multiple products and offer contextualized experiences to investors.

Incumbents in the custody market can protect their market share from disruptors by pivoting to this custody model of the future. Firms must also endeavor to invest in a hybrid system to manage both digital and traditional assets. This model will help reduce asset servicing costs and increase transaction speed and security for traditional assets; however, it needs to be tested in actual scenarios. This industry transformation offers custodians the opportunity to reimagine their data estate to enable real-time data analytics and decision support. Analytics and AI capabilities will serve as the gateway to build and deliver value-added services. Data-powered operations will result in efficiency gains for core trade processes such as cash flow monitoring and Net Asset Value (NAV) compliance.

Notably, global custodians are stepping forward with data and analytics tools to cut through the complexities of portfolio data and to support asset managers with powerful data-driven insights. Simultaneously, they are building end-to-end solutions that cover all asset classes. Cloud is the backbone that will enable the data-fueled platform's agility, flexibility, interoperability, and scalability. It will allow custodians to utilize the cognitive technology that hyperscalers and cloud technology providers offer to make the best use of internal and external data. However, platform-thinking is not about technology alone; it is a business model shift that encompasses the creation and delivery of value to each stakeholder in the ecosystem. Firms will experience a shift in their hiring plans, with traditional roles becoming obsolete as technology potentially eliminates functions such as reconciliation and transfer agency.

The future of custody and depository services is expanding the traditional model's sphere of influence and creating alternate avenues for growth and differentiation. Firms that are continuously experimenting with new technology and digital asset products will be at the forefront of their products and experience innovation. The platform-based operating model outlined in this study creates a robust foundational infrastructure to take advantage of this opportunity in a sustainable and resilient manner.

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