Custodian Banks and Settlement Instructions: Why Banks' Active Involvement and Increased Automation will Significantly Benefit the Industry

September 2011

Introduction

Motivated by rising administrative and staff costs and the need for increased settlement efficiency, members of the global custodian community have been assuming more responsibility for the maintenance of settlement and account instructions (SI). To gain a deeper understanding of the drive towards accurate and compliant SIs, Omgeo, the global standard for post-trade efficiency, conducted research amongst the world's leading custodian banks into the current thinking behind settlement and account instruction processes. The findings of the research are contained in this paper.

Key Findings

- Although there has been a heightened focus on risk management and increased levels of automation, up to 10% of custodian bank clients' trades fail or need amending after instruction, with inaccurate settlement and account details cited as a primary reason for these issues.
- Incorrect settlement and account instructions play a significant role in trade failure, with nearly 40% of respondents stating that 30% or more of their failed or amended trades are caused by settlement instruction issues.
- Most custodian banks (63%) believe that they should be more involved with the maintenance of SIs.
- Most respondents (75%) also believe that custodians increased involvement with settlement and account instruction management will be viewed favorably by the industry.
- 63% of respondents cited manual SI data and missing data as the main pain points when it comes to accurate settlement instructions.
- Custodian banks are primarily using manual methods to communicate SIs to their clients, with email identified as the most frequently used method. Other methods include fax, phone and mail/postal services.
- The SI process would be improved through the greater use of automation by custodian banks, by accelerating the trade instruction process and reducing the percentage of failed and amended trades.

What are SIs?

SIs, or settlement and account instructions, are a key reference data component in the trade life cycle. Settlement instruction data includes information such as place of settlement, account name and number, market, security type, bank identification codes and more. This data includes all of the account and settlement details that are needed for a trade to settle.

Background

Settlement and account instructions (SIs) have long been a problem for the securities industry. Questions around who should "own" and maintain the data, as well as problems with the data quality and remediation processes, have plagued the industry for decades. But there's a growing movement in the industry to shift some of the responsibility for maintaining settlement instructions to custodian banks rather than each bank sending SIs in multiple, often manual, formats to their investment manager clients. Many investment managers have been asking for this service for years – is now the time for this movement to finally gain flight?

To learn more about the role that custodian banks could play in the management of settlement instructions, Omgeo conducted a survey of the world's leading custodians in July 2011, asking a handful of questions to gain insights into their thinking on the challenges and the future of this key reference data component. The respondents included 8 of the top 25 global custodians and represented 70% of the world's assets under custody (source: globalcustody.net, September 2011).

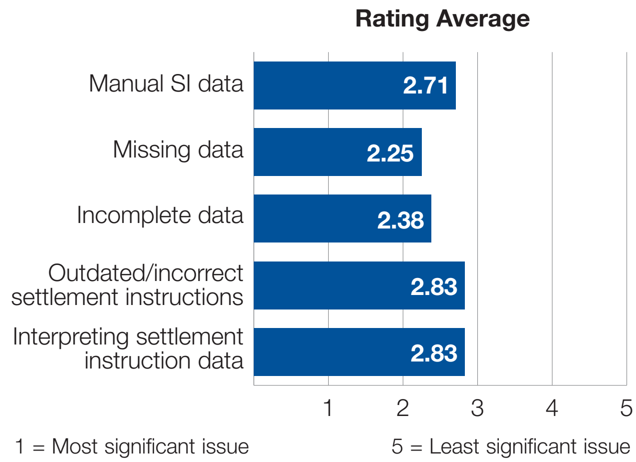
Why Trades Fail

While there are several factors that cause trades to fail, inaccurate settlement instructions have always been a key reason. Others include the broker's inability to locate shares and errors in other security reference data. According to the respondents to this survey, up to 10% of the custodian bank clients' trades fail or need amending after instruction. This rate is consistent with fail rates that have been reported for several years, indicating that little progress has been made in improving overall fail rates or perhaps that a natural floor has been reached given the tools and capabilities in the hands of the industry. Further, it's clear that inaccurate settlement instructions play a crucial role in causing failed trades. Nearly 40% of the respondents indicated that settlement instruction issues caused 30% or more of their trades to fail. Reasons for these types of issues include inaccurate settlement and account data within the actual SI, as well as cases where the incorrect SI was appended to the trade.

Respondents cited a number of key challenges with settlement instruction data *(see chart 1),* but the primary issues were missing data, incomplete data and the manual nature of processing the data. Unfortunately, the industry still relies on outdated, manual methods to remediate data errors. Today, custodians primarily rely on their client service representatives to contact the investment manager directly to resolve settlement instruction errors. Some custodians may even refer to old trades with the same counterparty to get the client's instructions, exposing them to risk and liability by entering the data on behalf of the client.

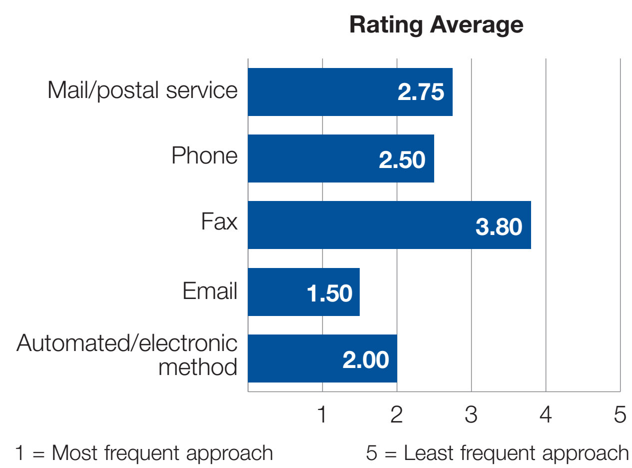
Further, custodians themselves are relying on manual or semi-automated methods to communicate their settlement instructions today. Respondents to the survey cited email as their primary channel of communication, with a semi-automated method (such as auto-generated email or fax) as the second most common method *(see chart 2).*

Chart 1: Settlement Instruction Pain Points



Question: What are your biggest pain points around settlement instructions currently? Please rank these in order of significance, using each number only once. Please only rank those issues you currently experience today.

Chart 2: SI Communication Methods to Investment Managers



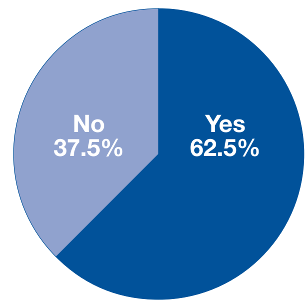
Question: How do you communicate your SIs to your investment manager clients today? Please rank in order of use, from the most frequent approach to the least frequent. Be sure to only rank those methods you actively use today.

Striving for Perfection

Clearly there's significant room for the industry to adopt automated solutions to improve the quality of settlement instruction data. Automation introduces greater control of data and compliance with industry standards. In the end, automation promotes an accelerated trade instruction process, provides a greater level of transparency and facilitates greater control over the operational process.

Another way that the data quality gap may be filled is if custodian banks take a more active role in the maintenance of their investment manager clients' settlement instructions. Nearly two-thirds of the respondents believe that the custody banking industry should be more actively involved in the maintenance of settlement instructions *(see chart 3).* There are a number of reasons for this, such as providing better service to their investment manager clients. However, the main reason is typically that a more active role helps banks to limit their work effort and risk. If SI data is incorrect, it means that the custodian does not have a good understanding of who they should be settling their trades with. It also means that the trade may need to be rebooked, which introduces additional overhead and costs. While some of these firms commented that they still believe that investment managers play a significant role in the settlement instruction process, most acknowledged that by taking a more active role, custodian banks could help reduce the risk of claims and compensation resulting from failed trades and also help the industry to achieve greater levels of straight through processing (STP).

Chart 3: Custodian Banks' Involvement with SIs



Question: Do you believe custodian banks should be more actively involved in the maintenance and updating of SIs?

Conclusion

So is this happening? According to the survey respondents, nearly two-thirds are getting more actively involved in settlement instruction management. Further, even more – 75% – believe that custodian banks' increased involvement in settlement instructions will be viewed favorably by the industry. Despite some concerns over taking on the additional task of managing this data on behalf of their clients, custodian banks see more and more clients asking for this service as they delve deeper into offering middle-office outsourcing.

As banks assume more responsibility for SI data and seek ways to increase their settlement instruction automation levels, there will be a very positive effect on trade failure rates. At a time where global regulators look to reduce risk throughout the trade life cycle, and where Europe appears poised to move to a T+2 settlement cycle, firms will face increased pressure to ensure that all of their trade processes are as efficient and transparent as possible – including the settlement and account instruction process. Increased custodian bank involvement and enhanced automation levels will help to make the SI process more efficient, accurate and effective for all market participants while reducing systemic risk across the industry.

About Omgeo℠

At Omgeo, we are the operations experts, automating trade life cycle events between investment managers, broker/dealers and custodian banks. We enable 6,000 clients and 80 technology partners in 46 countries around the world to seamlessly connect and interoperate. By automating and streamlining post-trade operations, we enable clients to accelerate the clearing and settlement of trades, and better manage and reduce their counterparty and credit risk. Our strength lies with our global community and our ability to adapt our solutions to enable clients to realize clear returns on their investment strategies, while responding to changing market and regulatory conditions. Across borders, asset classes, and trade life cycles, Omgeo is the global standard for operational efficiency across the investment industry. Formed in 2001, Omgeo is jointly owned by the DTCC and Thomson Reuters. For more information, please visit www.omgeo.com.

Americas
Omgeo LLC
22 Thomson Place
Boston, MA 02210
tel +1 866 49 OMGEO
askomgeoamericas@omgeo.com

Europe
Omgeo Ltd
Aldgate House
33 Aldgate High Street
London EC3N 1DL
tel +44 20 7369 7777
askomgeoeurope@omgeo.com

Singapore
Omgeo Pte Ltd
18 Science Park Drive
Singapore 118229
Tel: 65.6775.5088
Fax: 65.6323.4929
askomgeoasia@omgeo.com

Japan
Omgeo K.K.
Palaceside Building
1-1-1, Hitotsubashi, Chiyoda-ku
Tokyo 100-0003
tel + 813 5218 6621
askomgeojapan@omgeo.com