Summary

- Pension schemes' worlds are getting more complicated – and custodians have seized the opportunity to broaden their offerings.
- Greater sophistication and diversification of investments have made custodians' role more complex.
- They've also become trusted collaborators in DB schemes' de-risking journeys, and are supporting trustees in new ways when it comes to buy-ins and longevity transactions.
- Technology is helping custodians become more sophisticated than ever. As client expectations increase, custodians are expected to provide settlements more quickly than ever before.
- Blockchain is another exciting area to watch; custodians are aware of the possibilities it creates and investing accordingly. Watch this space.

From safekeepers to trusted partners

How custodians have moved up the value chain and broadened the support and services they offer to pension schemes

Once upon a time, custodians were purely the safekeepers of pension schemes' assets. While that vital function remains at the heart of what they do, custodians' role as a trusted partner to pension schemes is continuing to develop. Their services are expanding accordingly.

As MJ Hudson Amaces managing director, Tom Robertson, explains: "There was always this historic view that a client and a custodian relationship was very much master and servant, and the custodian was there to provide a service. However, as investment portfolios became more sophisticated and regulations became more complex, the custodians saw an opportunity to move up the value chain in terms of the services that they were offering to clients."

Moving closer to the endgame

While the gilts crisis caused a multitude of issues for pension schemes, there was one significant upside for defined benefit (DB) schemes. Many experienced sharp upticks in their funding levels. Trustees have enlisted their custodians to help them as they move towards their end game, whether that's the insurance route, in the form of a series of buy-ins or a buyout with an insurer or a longevity swap, or alternatively, self-sufficiency.

Custodians swap assets for insurance policies over time, on behalf of DB schemes that have opted for the insurance route. There are also more specific ways custodians can help with different types of insurance transactions.

For instance, custodians can help trustee boards that opt for a longevity swap. Usually, in risk transfers, collateral structures are used to hedge against potential future risks, such as the scheme membership living for longer than expected. A collateral manager is needed to independently hold those positions and move collateral between the two parties – and custodians are taking on that role.

In a buy-in, a custody manager can help a DB scheme to get its assets ready for its chosen insurer. "Whilst we can be pure custodians, we also have the ability to do things like transition management to put the assets in the correct shape for the insurer and then transfer to the insurer on the given day," says Northern Trust pensions and insurance executive for EMEA, Mark Austin.

Diversification

As pension schemes seek to invest in a wider range of asset classes and access private markets, custodians' roles are also becoming more sophisticated. "It's a far more complex environment than it was a few years ago," agrees Robertson. "And I think that to service those assets potentially requires a different and increased skillset within the custodians and in terms of the individuals that they're recruiting into the teams. They need to be more au fait with the workings of the markets than they needed to be 10 years ago."

All of this comes at a cost. Robertson says: "If you want more knowledgeable staff, you need to pay for it. I see that across custodians at the moment: The rising cost of being able to serve their client base is pushing custodians to focus on things like profitability and cost across their clients."

Data and technology

Among his roles, Thomas Murray director and head of advisory and analytics, Stephen Merry, runs custodian selection processes on behalf of pension schemes and other global institutional investors. He observes: "One of the themes that we have seen, certainly in the last five or six mandates that we've run, is around data and technology. The clients aren't just looking for the custodians to look after their assets anymore. They want the custodians to essentially be extensions of their operations and also provide them with timely and accurate data, directly into their own platforms."

Austin is also seeing this trend, not just in data but in clients' expectations around settlement timeframes, which are getting much shorter. "We have seen a move in the USA already to T plus one *[settlement taking place a day after a transaction is complete]*. It is only logical that the next move will be to T zero. Schemes are going to be asking for much more real time data on a daily basis and also a lot more real time cash around having to cope with these shorter timeframes in the market."

The bird's eye view that custodians have of ESG data is also increasingly important to clients, even proving decisive in winning custodians business, reports Robertson. Investors need to understand more about their ESG commitments and have access to reporting tools to meet their regulatory requirements. The custodian is the person that's ideally placed to deliver that, he believes.

"Custodians saw an opportunity to move up the value chain in terms of the services that they were offering to clients"

Robertson says: "I've seen a couple of custodians winning more business from an ESG perspective almost than they have been from a core custody perspective. So, I wouldn't go as far as to say that custodians are becoming advisors. But they are certainly increasingly becoming a partner to pension schemes."

Outsourced trading

The Covid-19 pandemic made life much more challenging for asset managers, as trading volumes increased sharply. Many asset managers and hedge funds routed orders to third parties for execution, according to a BNY Mellon white paper. BNY Mellon head of institutional equities sales, Ron Hooey, says that the pandemic has "put fuel on the fire" of the outsourced trading trend. "Anyone who was thinking of outsourcing is now doing it."

"Some of our custodians are offering that service to clients," agrees Merry. "But we haven't seen it form a significant part of the buying criteria for any of our clients at the moment. That's not to say it won't in future – it's an interesting area."

Blockchain

Blockchain offers many exciting possibilities to pension schemes, Austin believes. "Blockchain gives you the ability to take something my size and turn it into 5,000 ants," he explains. "So, you can use it to turn something like an alternative asset into tiny portions, creating the possibility for schemes to hold a tiny portion of the overall asset. It is an interesting way of potentially getting more alternatives into more portfolios and creates more liquidity. Down the line, there is the potential to create tokens to make alternatives more accessible."

While blockchain is exciting – and an area in which Northern Trust, among other custodians, is investing as a potential source of long-term growth – it is not on most schemes' radars at the moment. Merry says: "It's important for custodians to be thinking about catering to it. We believe it will come in at some point, but we're not seeing it at the moment."

Robertson thinks custodians' interest and growth in this space will go beyond blockchain. "The whole space of digital assets, cryptocurrency and digitisation – towards the end of 2022, there was a huge fanfare about digital asset custody. The banks spent a huge amount of time developing digital asset products. I think that side of the market will grow significantly, but we need to see a lot more regulation in terms of digital assets before we start to see the flows into that asset class that people are expecting."

The role of the custodian has certainly evolved – and they look set to play an ever-more important role as technology continues to advance at a rapid pace.

Written by Louise Farrand, a freelance journalist