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TREASURY Topics

The Case for Centralized Trust and Custody Relationships

Few people do without automobile insurance even though annual policy premiums can easily run into the thousands of dollars. That's because an insurance policy provides financial protection from common driving miscues and catastrophic incidents. Without it, a few fender benders, a cracked windshield, and couple of parking-lot dings could amount to a substantial out-of-pocket expense-and the financial liability of a catastrophic auto accident could seem limitless.

The same argument can be made for mitigating your institution's investment risk by having a centralized trust and custody relationship. This relationship is a contractual agreement with a third-party bank to provide professional services, including independent safekeeping of assets, settlement and reporting of transactions, and income and cash transfers.

A centralized trust and custody arrangement also provides a consistent, single source of aggregate portfolio reports based on your particular cost and accounting assumptions. These reports can serve as an early warning of critical deviations from your investment policies, letting you eliminate their impact on your general ledger and financial statements.

As well, a trust and custody arrangement increase your operational efficiency freeing up personnel now tasked with vetting and reconciling multiple monthly management reports. And it eliminates the liability you would face in the event of a catastrophic financial-reporting oversight.

Simply put, centralized custody is the cornerstone of portfolio risk management. Unfortunately, too many institutions lack such agreements and leave themselves financially vulnerable as a result.

Preventing small problems from becoming large ones

Institutions without a centralized custody relationship often assign that responsibility to one or more asset managers or to a broker's back-office staff. At month end, the manager or staff submits a variety of accounting and risk reports. Often these reports are accepted with very little review or audit, immediately violating the number-one rule of risk management: establish checks and balances.

A custody bank, by contrast, provides independent, daily verification of portfolio assets, transactions, and risk characteristics, as well as asset safekeeping. It also provides a single source for aggregate portfolio accounting reports, one that uses a pre-defined and consistent data set to measure portfolio risk, compliance, and performance-and to warn you if any of those metrics deviates from your investment policies.

Missing such a deviation is easier than you might imagine. At the data-gathering level, managers often report using different pricing sources, industry or sector classifications, and bond characteristics, resulting in inaccurate measures of portfolio compliance and performance. These inaccuracies can impact every facet of investment risk and accounting, including income forecasting. In the case of bonds with embedded options, these inaccuracies can dramatically distort a portfolio's risk/return profile.

Inconsistent accounting assumptions can also dramatically impact an institution's financial reports. Consider the organization that aggregates reports from several external managers without confirming that each has used the same accounting assumptions. In the worst-case scenario, the different accounting methodologies are aggregated and errors are passed unchecked into the general ledger and quarterly earnings statements.

In our practice, we have identified five common accounting assumptions that affect monthly entries if they are not kept consistent across managers:

1. Amortizing security premiums to their maturity date versus first par call/put date;
2. Amortizing security premium on a straight-line basis versus a constant yield/scientific method;
3. Using various and inconsistent costing methods;
4. Using various and inconsistent security-sell methods (LIFO, FIFO, HCFO, LCFO, etc.); and
5. Reporting on a trade- versus settle-date basis.

Our experience is that in almost every case where a client is aggregating manager-generated reports for general ledger entries there are inconsistencies from combining disparate accounting methodologies. Centralizing the custody of portfolios eliminates these methodology mismatches because a custody bank utilizes client-driven accounting assumptions to generate consistent accounting data for monthly entries.

The personnel payoff

Beyond the data-driven benefits, however, centralized trust and custody relationships can make a significant, positive impact on an organization's day-to-day efficiencies, employee satisfaction, and strategic-planning capabilities.

Think about the time it takes for internal personnel to aggregate and reconcile an organization's monthly manager reports. They were hired to use for their intellectual capital: for their abilities to accurately account for company assets, make investment decisions, and strategically plan for future business developments. Instead, they are forced to scrub data, monitor compliance, and create reports: mundane tasks for which they were not hired and are overqualified to perform. Not only is the organization misapplying these human resources, it is at risk for losing them.

Protecting against disaster

In addition to a misallocation of internal resources and employee dissatisfaction, there is a far more serious reason not to perform these functions in-house. Most institutions carry limited insurance against a ruinous scenario, such as restatement of earnings that dramatically impacts goodwill or share value. These mistakes go straight to the bottom line and strike at the heart of financial viability.

By establishing a centralized custody and trust arrangement, not only can you reassign people to tasks that makes the best use of their talents, you place your insurance and liability burden where it belongs: squarely on the shoulders of your custody agent.

Is it worth it?

In the past, we have heard two primary objections about professional custody services: a lack of comprehensive reporting and high custody fees. It's a fair point. Why pay for something that doesn't even begin to meet your needs?

Today the landscape has changed markedly. Custodial institutions offer a number of reporting solutions to match the needs of institutional investors, handling everything from off-cycle accounting periods to income detail reported at the individual security level. Some even offer complete reporting packages that institutions can customize for their reporting needs.

And prices have dropped significantly.

Today, top-tier custody banks charge a fee of between 0.01% and 0.03% annually for assets above $250 million (0.02% on a $500 million portfolio is $100,000 annually, which generally includes unlimited transactions).

In our view, the advantages of a centralized custody arrangement-independent asset safekeeping; consistent, accurate, and client-driven portfolio accounting; and improvements to operational efficiencies-more than compensate for the costs.

To see these benefits for yourself, do the following:

- Discuss the five accounting assumptions outlined earlier with your managers and gauge the potential impact of any inconsistencies you discover;
- Identify the internal resources used in monthly report aggregation/reconciliation and decide if those resources are better spent elsewhere; and
- Based on your investigation, assess the value of obtaining operational insurance. Chances that the operational risks and inefficiencies of not having a centralized custody relationship will make clear the need to establish one.

As clear as the need for automobile insurance.

Disclaimer

The information provided in this article is the result of experience with investment accounting issues and interaction with accountants and investment service providers. It is not intended to be relied upon substantively; rather, it is intended to inform and provide a discussion framework that treasury practitioners, internal management, and accounting and audit staff can use to discuss the impairment process.

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