

**Federal Reserve Bank of Boston
Meeting Minutes**

To: Basel II ANPR Public File

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From: Patrick deFontnouvelle and
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Subject: Mellon Global Securities
Services

Attendees: Mellon Financial Corporation (Mellon) representative: Jim McEleney, First Vice President; Federal Reserve Bank of Boston representatives: Linda Barriga and Victoria Garrity.

Purpose: To obtain information on competition in the custody business in connection with a study to assess the competitive impact of the Basel II Operational Risk capital charge.

Perspective: Mellon is a financial holding company with total assets of \$34 billion. Headquartered in Pittsburgh, Pennsylvania, Mellon provides institutional asset management, mutual funds, private wealth management, asset servicing, human resources services and treasury services for institutions, corporations and high net worth individuals. Mellon has approximately \$3.6 trillion in assets under management, administration or custody, including more than \$675 billion under management. Mellon provides custody services on a worldwide basis. They operate on a standalone basis in the U.S., through a joint venture with CIBC in Canada, and through a joint venture with ABN Amro in Europe and Asia.

Key Points Discussed:

1. Definition of Custody

In the early 1970s when ERISA (Employee Retirement Income Security Act) was enacted, U.S. custody was comprised of two core services: safekeeping and valuation. As the market matured in the 1980s and 1990s and custody margins thinned, custodians began offering value-added products in a bundle with these core custody services. These value-added services enhanced revenues and provided a source of growth and consist of: performance measurement, securities lending, foreign exchange, cash management, transition management, commission recapture, and fiduciary services. Since the introduction of value-added services, bundling has become more prominent. There is a natural advantage custodians have in providing some services. For example, there is an advantage in providing performance analytics as custodians can provide such a service faster/more efficiently than non-custodian providers. If a client wants custody only, they will receive a much higher price for the custody services than if they were purchasing custody as part of a bundled service. Bundling has also become more predominant as clients are looking to shorten their vendor list. Those services most typically bundled with custody are performance analytics, securities lending, and cash management. Those services that have a greater probability of being separated from the bundled custody product are foreign exchange, transition management, and commission recapture.

Bundling is more prevalent in the U.S. than in other parts of the world as the U.S. custody market is farther along the development curve. Europe is moving towards bundling and the Asian custody market is evolving, but at a slower pace than in Europe as Asia is just

currently undergoing deregulation and privatization of pensions.¹ The European custody market today is about where the U.S. custody market was in the late 80s. This is one reason why European banks are not major competitors in the U.S. custody market – capabilities of European providers tend to be more custody-only whereas customers in the U.S. have required a range of services from their custody providers. Another reason is that European banks may not have the information integration/reporting capabilities and this is important. Custody is a commodity and providers differentiate themselves not only by providing value-added services, but also by providing a user-friendly front end to clients to access their information.

Recently, the trend in custody has been to add another group of value-added services. These services, which can be called investment manager support services, consist of software licensing, hosted solutions, and middle and back office outsourcing. These services may not be bundled and a client may or may not necessarily purchase these services from their custodian given the structure of the client decision making process. It is the plan sponsors that select a custodian, but the asset managers (who manage the plan assets) who make the outsourcing choices. However, the majority of competitors providing these outsourcing services are custodians as they can provide these services at a lower cost and more efficiently.

2. *Nonbank competition in the Custody Market*

Mellon does not really see many nonbanks as competitors in the custody market. There may be several nonbank competitors who provide performance measurement services. In securities lending, they may see targeted competition by third party agent lenders and broker dealers. Such third party agent lenders are more prevalent in the U.S. than in Europe. Mellon does not view software providers as competitors, but noted that a recent trend is for custodians to acquire software providers.

3. *Custody Data Sources*

There are four primary surveys in the custody industry: R&M Custody, Global Custodian Magazine, Global Investor Magazine, and R&M Fund Administration Survey. R&M and Global Investor emanate out of Europe.

¹ One of the explanations as to why bundling has been slower to evolve outside the U.S. is that non-U.S. investment managers have not been subject to the pricing pressure to which U.S. investment managers have been subject.