



Chapter 6 – Risk

5 Questions

What is Risk?

Risk is the quantifiable likelihood of loss or underperformance of invested assets.

While risk presents opportunities for profits, especially through market risk management, it also poses major loss potential:

01

Lehman Brothers'
collapse in 2008

02

Collapse of subcustodians
or central securities
depositories (CSDs)

03

Missing
significant
corporate actions

04

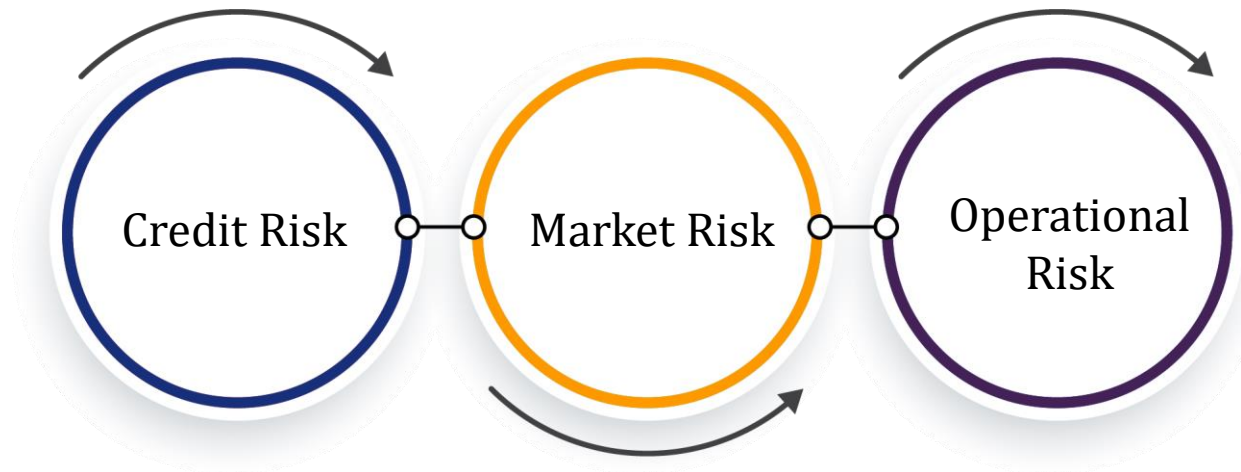
Events like
terrorist attacks

05

Large losses due to
rogue trading, such as
Barings Bank in 1995

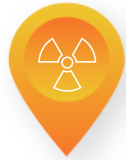
Bank for International Settlements (BIS): What is Risk?

The Bank for International Settlements (BIS) identifies three main categories of risk in the financial services sector:



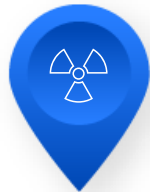
What is Risk?

Systemic Risk

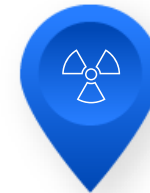


Risk of collapse affecting the entire financial system or market

Liquidity Risk



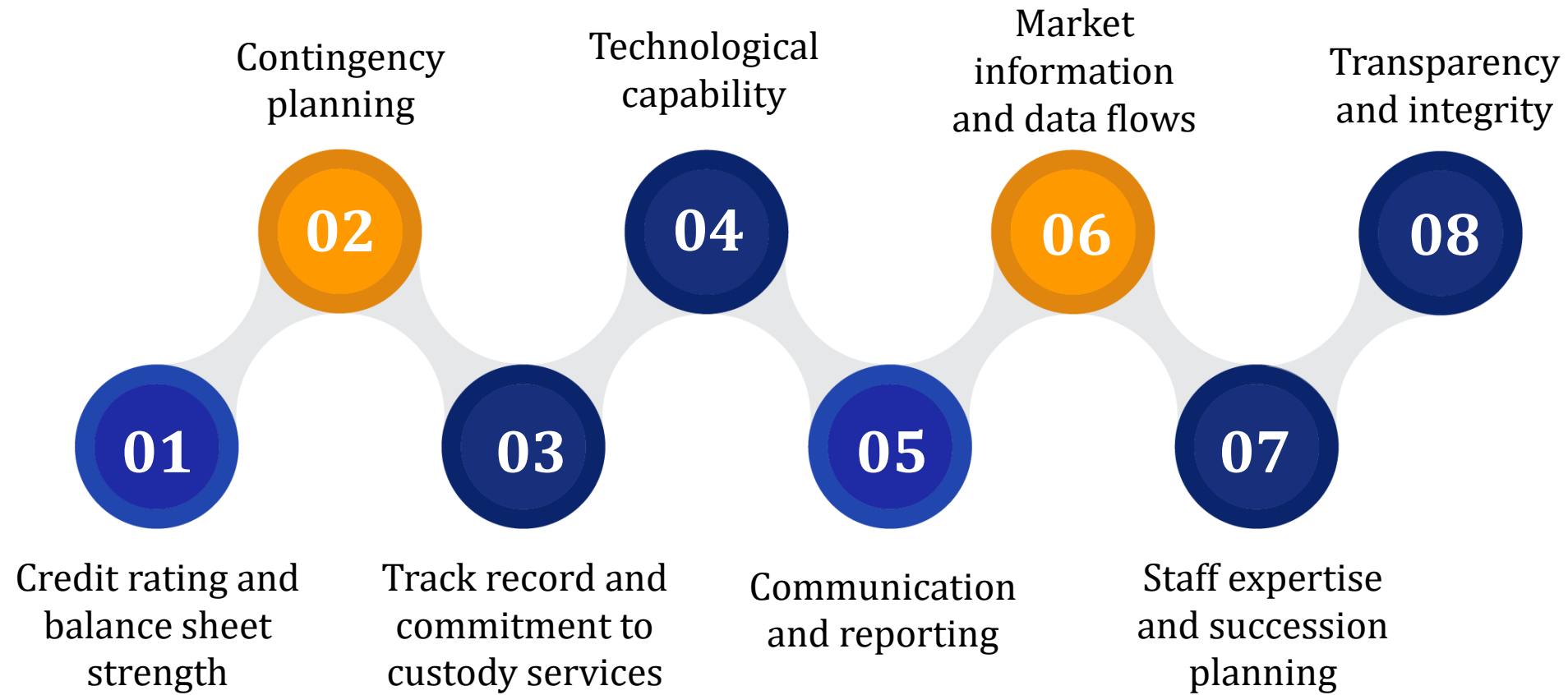
Risk related to the ease of quickly trading a security or financial asset



Involves selling an asset to realize cash without significantly affecting the market price

Risk Reviews of Market Infrastructure

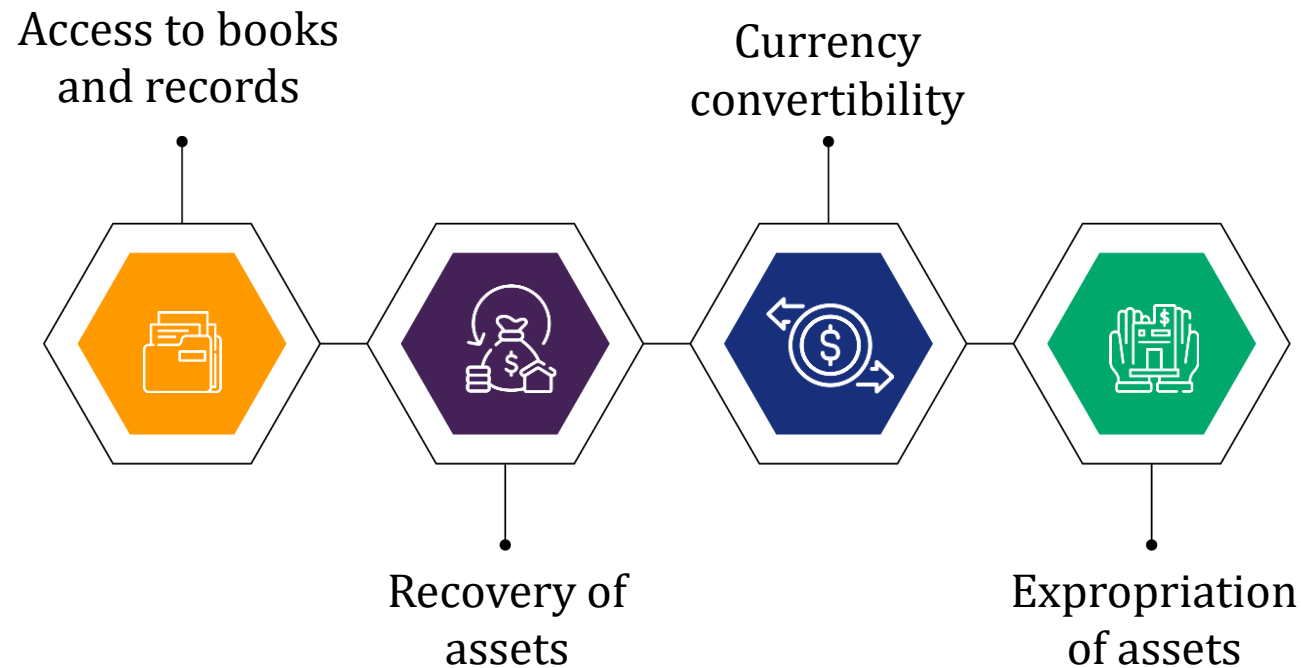
Risk reviews on Sub-Custodian networks consider these areas:



Risk Reviews of Market Infrastructure

SEC Rule 17f5 states that US investment companies can hold securities with any custodian that meets the SEC's eligible foreign custodian criteria.

Therefore, the following considerations should be made:



Risk Reviews of Market Infrastructure

SEC Rule 17f7 states that any depository that is employed by a US investment company to hold its assets must be an eligible foreign depository.

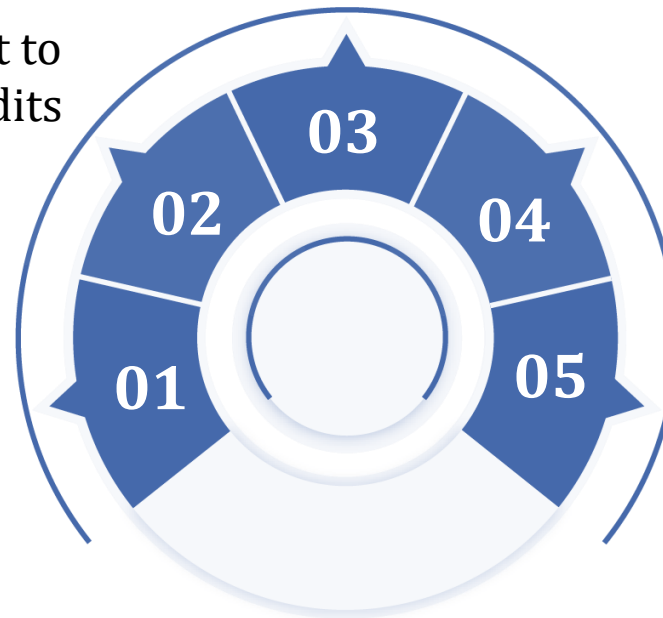
Therefore, the following criteria should be met:

Must provide regular reports to all depository participants

Must be subject to periodic audits

Must apply equal safekeeping treatment to each depository participant

Must be national or transnational centre for handling securities that is regulated by foreign financial regulatory authority

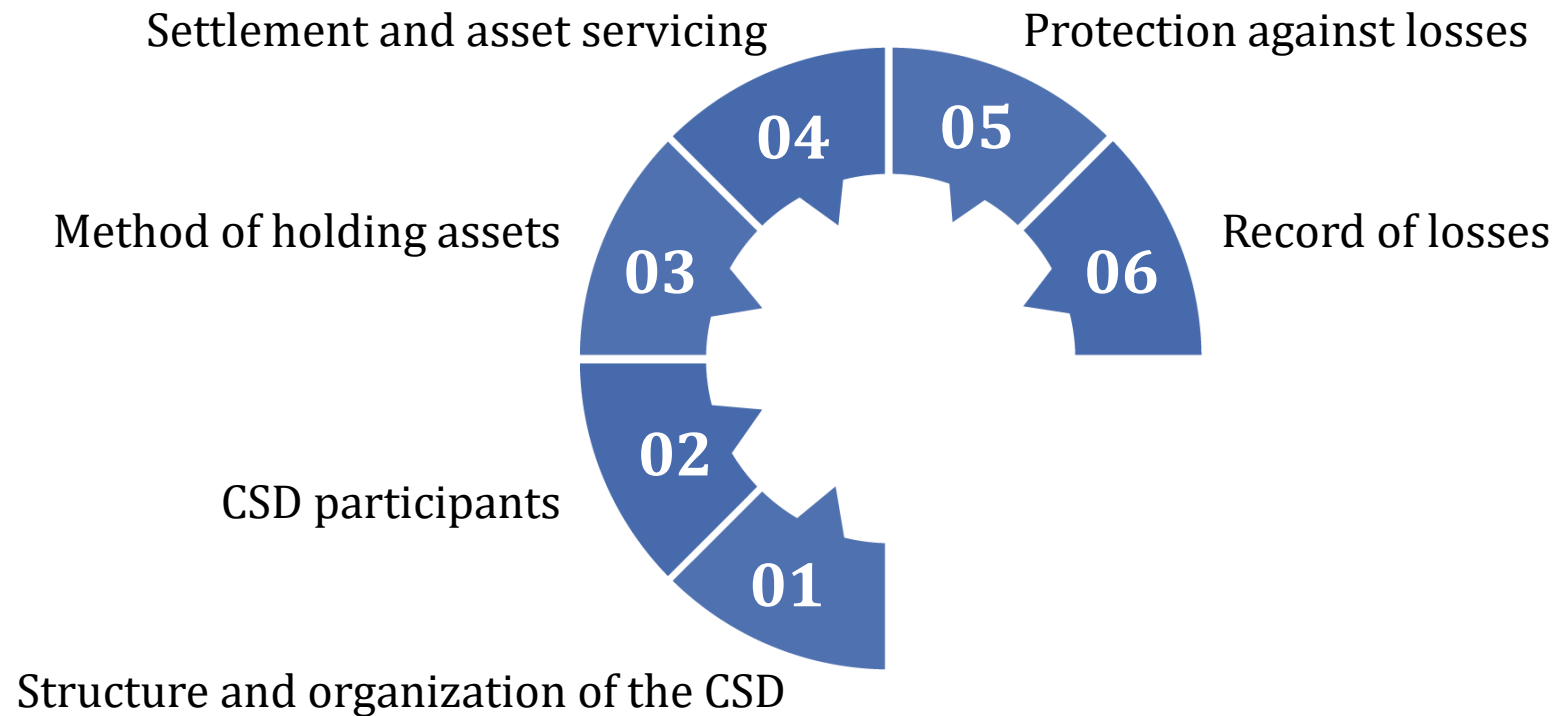


Must maintain a register for the assets held on behalf of each depository participant

Risk Reviews of Market Infrastructure

The AGC requires member custodians to submit 1 consolidated risk report.

These are the components covered in the report:



Settlement Risk

The CISI GSO learning manual has identified 12 sources of trade and settlement risk along with the proposed countermeasure.

#	Cause	Countermeasure
1	Late receipt of trade data or trade instructions	Maintain agreed operating procedures. Employ electronic communication link.
2	Inability to verify instructions from investment manager	Ensure timely pre-matching of settlement instructions. Employ standardized/automated electronic data flow. Use trade matching systems.
3	Inaccurate/outdated pricing feeds for listed and unlisted securities	Periodically check prices against a range of information sources and market vendors supplying pricing data.
4	Acting on an unauthorized instruction	Ensure instructions carry valid signatures, or other authorised security procedures. Accurate and up-to-date documentation must be maintained by the custodian on who is authorised to give client instructions.
5	Transaction with a failing counterparty	Use of CCP that assumes counterparty risk through novation. Send periodic analysis of settlement failures to the client.
6	DvP settlement infrastructure unavailable	Secure DvP on books of a creditworthy settlement bank. Employ ASDA. With CSDA, positions should be collateralised so that they can be reversed if necessary.

Settlement Risk

#	Cause	Countermeasure
7	Late delivery of securities and/or cash	Prompt follow-up of shortfall with counterparty. Initiate compensation claim against defaulting counterparty. Initiate a buy-in of securities.
8	Failure of trading parties to adhere to market standards/codes of practice	Industry associations and market practice groups to promote the use of industry standards and global best practice. Potential use of price discounts for settlement messages communicated by ISO standard.
9	Lack of reliable and timely dividend/corporate action information	Use multiple information sources to collect information on forthcoming corporate events. Sub-custodians should be responsible for providing timely information of client entitlements.
10	Delayed income collection	Dividend, interest and redeemable principal should only be credited on due date if timely payment is expected from issuer. Provision should be made in the custody contract to allow credit to be reversed if funds are not actually received from the issuer.
11	Inaccurate or late reporting to client	Need to implement improvements in reporting system. Need regular reconciliation of predicted with actual positions.
12	Clients' instructions not implemented or implemented incorrectly	Four-eyes principle involving checking instructions by another person. Forward value payment or delivery instructions to be held in a diary system, which is to be reviewed daily.

Risks Associated with Contractual Relationships

Global Custodians should take the following measures to mitigate the risks of entering into contractual relationships:



Custodians must ensure complete and unambiguous custody agreements with institutional investor clients



Maintain accurate and current documentation to comply with KYC requirements



Custody contracts must be directly signed with investment managers

Risks Associated with Contractual Relationships

When an investment manager is managing assets as an agent on behalf of a beneficial owner, the custody relationship will be between the custodian and the beneficial owner.

Legal contracts between these parties should include:



Clear instructions must specify which directions custodians should accept directly from appointed investment managers.



Set explicit credit limits for FX transactions and overdrafts



Maintain regularly reviews to ensure compliance with investment standards and timely receipt of instructions

Financial services companies must demonstrate robust and efficient internal control procedures

The Institute of Chartered Accountants in England and Wales (ICAEW) provides guidelines to help directors verify the strength of internal controls within their organizations

→ Let's take a look at the AAF 01/20 guidelines...

AAF 01/20 provides the following:

Generic guidance to a service auditor reporting on specific services performed by the service organization

High-level guidance to senior management who prepare the report on the service organisation and clarifies their responsibilities. This includes:



Description of the services provided



The governance arrangements and supporting infrastructure

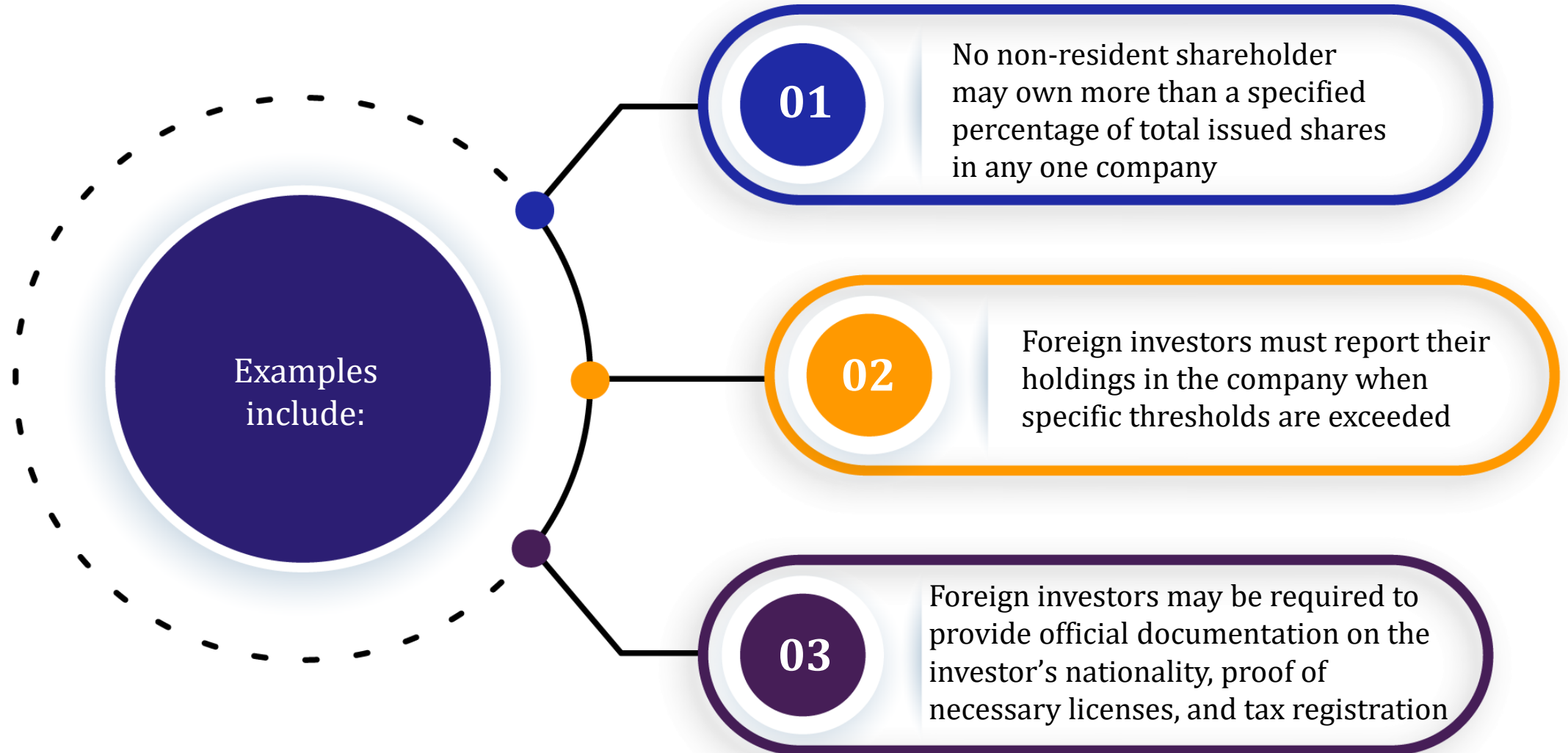


Control objectives and activities with an enhanced management statement

Helps user organisations understand the scope and type of assurance provided in the service auditor's report.

Shareholder Limits and Restrictions on Foreign Investment

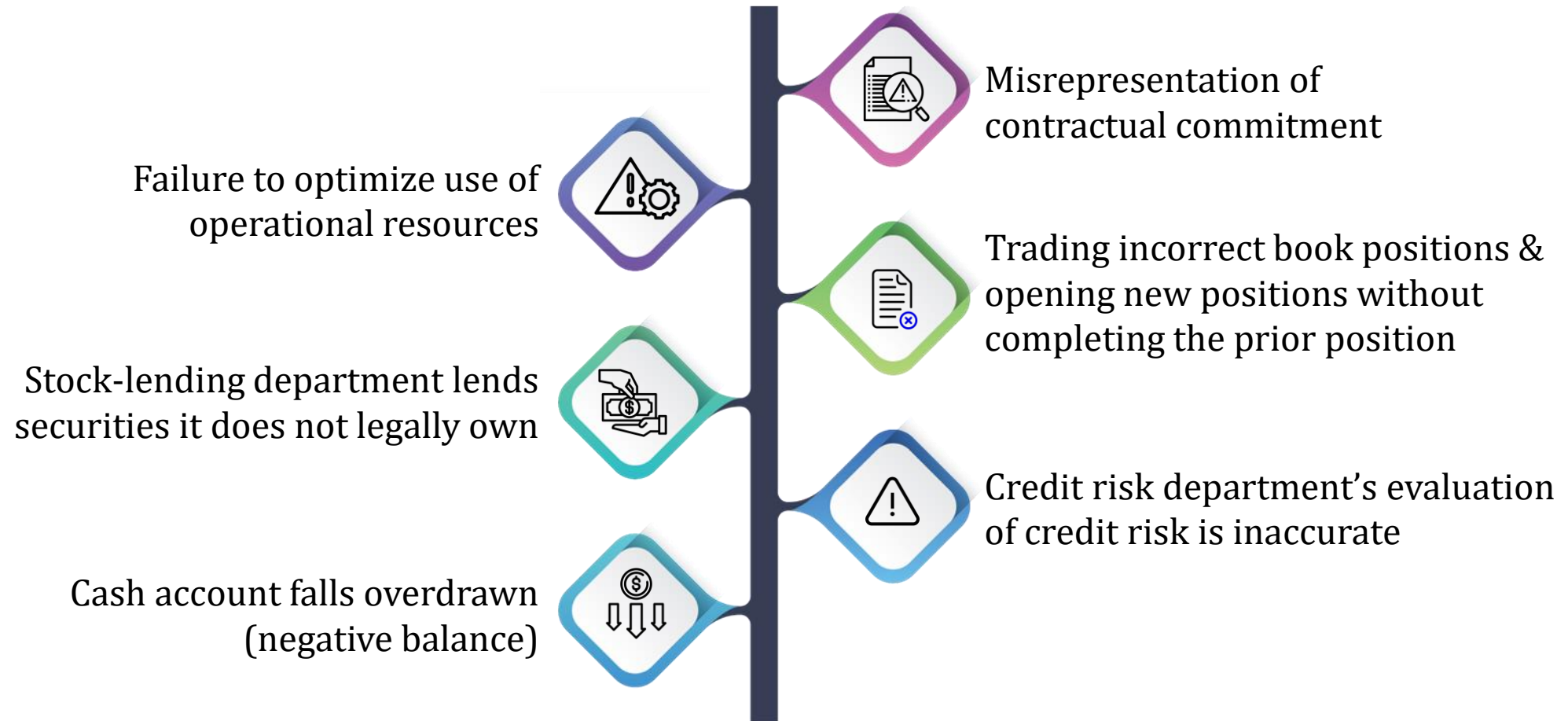
Share ownership on foreign investment may be restricted in some companies or sectors.



*Detailed list available in the CISI GSO textbook

Mitigating Risk Through Reconciliation

Cash and securities reconciliation involves matching internal balances, transactions, and holdings with those held by external providers. Lack of effective reconciliation presents the following risks:



Similarly, a firm will perform a comparable cash reconciliation process for custodian nostro accounts.

Assets and Entitlements

Regular reconciliation of asset holdings also aims to detect:



Unauthorized removal of securities from firm accounts at the custodian



Unexpected receipt of securities



Errors in updating ownership records after transaction settlements.

Financial services face continuous and increasing regulatory reforms. Here is an example discussed previously:

In 2007, MiFID was the first step to creating a more harmonised financial services environment within Europe.

In 2018, this was revised with MiFID II – this affected all stages of the life-cycle of transactions and many consumer/firm-related post-trade requirements.

→ Regulatory changes and reform will continue in the foreseeable future...

Which rule in the US states that investment companies can hold securities with any foreign custodian that meets the SEC's criteria?

- A. AAF 01/20
- B. Rule 17f5
- C. Rule 206(4)-2
- D. Rule 17f7

EXAM FOCUS™

Finally.....Thank you & Good Luck

