Market slump: Custody agreements and counterparty risk

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The recent tumultuous economic developments have led to volatile and unpredictable market conditions. While we cannot forecast what will come next, a number of protective steps can be taken, and these are summarised below.

Overview

Current market conditions dictate that very close scrutiny will need to be paid to counterparty risk. Custody agreements can be an overlooked risk area: it may be surprising to know that in some instances title to the custodied assets can pass to the custodian leaving the client very exposed in the event of insolvency. The note below addresses this and other pressure points in more detail, and highlights potential ways of managing this risk.

Custody agreements can also give rise to problems in light of the Finance Act 2008, leading in some circumstances to offshore assets being accidentally remitted to the UK leading to potential UK tax charges of up to 40%.

Custody agreements and counterparty risk

In the wake of the collapse of Lehmans and others, there is increased focus on counterparty risk for bank deposits and investments. What is often easily overlooked is that similar risks can arise even where assets are custodied with banks.

Where the bank is custodian, it assumes responsibility for the safekeeping and administration of deposits. Typically, as custodian the bank will hold equities, bonds and other forms of investments. In essence, the custodian holds as nominee for the client, who retains ownership of the assets, so minimising risk from counterparty exposure.

However, there are three main areas where there may be risk exposure, summarised below, and we would advise that the terms of custody agreements be reviewed in this context.

(i) Security. In many custody agreements the custodian is entitled to take title to some or all of the custodied assets where there is any lending to the client (lending can arise in a wide range of circumstances, including collateralised transactions, swaps, derivatives and loan arrangements). Depending on the terms of the agreement, the custodian may be allowed to take ownership of all the assets as its own, notwithstanding that they may be worth far more than the amounts loaned. Were the custodian to become insolvent, all of those assets could be at risk. In the first instance the position should be checked under the relevant custody agreement, and then it may be possible to limit the value of the custodied assets to which the custodian can take title.

(ii) Pooling. Typically the custodian aggregates fungible assets such as cash or securities of a particular issue which it holds for its various clients in one commingled account. While the custodian is required to maintain proper records showing each client's title to the pooled assets, if these records are not properly maintained complications would inevitably arise in the event of the custodian's insolvency. It is often possible to agree that assets will not be pooled, but this may well come at the cost of not then being able to undertake transactions which involve any element of lending by the custodian. Restrictions on lending transactions may be dealt with in other ways. As regards stock lending transactions, greater security can be obtained by cash-collateralising the arrangement through a repo.

(iii) Typically all investments in foreign equities or securities, will involve the appointment of a sub-custodian. Concerns arise if any of the sub-custodians are based in jurisdictions where the custodians do not operate as nominee for the client but may take title to the custodied assets. If the sub-custodian becomes insolvent, clients will simply rank as unsecured creditors of the foreign custodian in a foreign insolvency proceeding rather than having a right to reclaim the assets. Custodians will be able to provide details to clients as to whether any assets are held by sub-custodians in jurisdictions where the assets are not held by the custodian as nominees.

While it may be entirely appropriate to take the view that a number of investments remain desirable notwithstanding potential risk exposure these decisions are best taken on an informed basis.

Further potential pitfalls

Counterparty exposure inevitably arises beyond the sphere of custody agreements, for example:

(i) Products designed to replicate investment exposure to a broad range of markets or indices, in particular emerging markets, without direct investment. This is often achieved by placing the investment with one counterparty. These arrangements may achieve economic efficiency but with the downside of exposure to a single counterparty.

(ii) Where investments are made through insurance structures, the investor is entirely exposed to the insurance provider as counterparty.

Custody agreements and accidental remittances

Where lending transactions take place in the context of custody agreements, this can give rise to unexpected tax consequences for non-domiciled clients using the remittance basis. Depending on the structure of the transaction, these arrangements can result in an unintentional remittance of offshore funds to the UK. This could trigger UK tax at up to 40% on the amounts treated as remitted.

This risk may be mitigated by limiting the assets over which security can be taken to only those assets which could be remitted without triggering a UK tax charge. Of course, the precise amendments required will vary according to factors including the nature of the custodied assets and whether they are directly held or held in trust.