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Report on Third Party Reporting

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I. INTRODUCTION

1. A Working Group on Third Party Reporting (Working Group) was established by the IMF Committee on Balance of Payments Statistics (the Committee) in October 2000 to determine the feasibility of developing partner country sources for securities held with nonresident custodians as a means of addressing gaps in collection systems used for the Coordinated Portfolio Investment Survey (CPIS). Thus far, the activities of the Working Group have been confined to discussions with U.S. and U.K. global custodians.

A. Gaps in CPIS reporting

2. A number of countries that participated in the 1997 Coordinated Portfolio Investment survey (1997 CPIS) expressed concern that there might be gaps in the coverage of their CPIS due to; (i) portfolio investment by some nonfinancial corporations not being covered in their end-investor surveys, and (ii) portfolio investment by households being only included if households use the services of resident custodians.

B. Exploring Partner Country Sources

3. One way of filling these gaps is to explore the possibility of developing partner country data sources through reporting by nonresident custodians. However, for portfolio investment by nonfinancial corporations, there is a significant risk of doublecounting when partner country sources are combined with reporting by end-investors. For this reason, attention has focused on the potential for developing partner country data sources for portfolio investment by households that use the services of nonresident custodians, as, for this group of investors, there is less risk of doublecounting.

4. In addition to conducting surveys of resident custodians to collect data on portfolio investment assets (for their CPIS), some countries have established surveys of resident custodians to collect data on portfolio investment liabilities (securities issued by residents that are held by a resident custodian on behalf of nonresidents). In the latter case, if the nonresident can be identified as part of the household sector in their country of residence, this is a potentially useful existing partner country data source. It is likely that the same applies to securities issued by nonresidents that are held by a resident custodian on behalf of nonresidents, although these data are not currently collected. In both cases, such holdings comprise a potentially useful partner country data source, providing that the custodian can identify the nonresident households' country of residence.

5. Experience with custodian surveys of portfolio investment liabilities suggests that custodians cannot always determine whether the holder is an intermediary or the beneficial owner. This is especially likely to be so in cases where the client is a financial institution, as the custodian is less likely to know whether the client is acting on behalf of another party. This conclusion was confirmed by the Working Group's discussions with custodians, and is another reason for limiting the scope of third party reporting to nonresident households, as nonresident households are unlikely to be acting as intermediaries.

6. The feasibility of developing partner country sources as a supplement to portfolio investment collection systems was discussed in the final report of ECB's *Task Force on Portfolio Investment Collections Systems*, June 2002. The report concluded that it was technically feasible for some European Union (EU) member countries to conduct third party reporting through their custodians, either on an aggregate or security-by-security basis. It concluded that such a survey should be annual, confined to the reporting of positions, and to nonresident households. It was concluded that the survey could provide a useful source for filling gaps in international investment position data for portfolio investment assets of member countries. The report recommended that a pilot survey of custodians in EU member countries should be conducted as a follow up to the work of the Task Force.

C. Goals for a Pilot Third Party Custodian Survey

7. An initial goal would be to determine the orders of magnitude that are involved. If a pilot survey of custodians by CPIS compilers indicated that the value of securities held on behalf of third party households is substantial, this would establish a prima facie case for taking the project further. A second goal would be to establish how reliably custodians can identify a nonresident household as the beneficial owner of a security.

II. DEVELOPMENTS IN THE CUSTODIAN INDUSTRY

8. The following draws on the discussions held by the Working Group with U.S. and U.K. global custodians.

A. Back-Office and Related Services

9. The core function of a custodian is to provide safekeeping and settlement services either directly for the owners of securities or for intermediaries acting on their behalf, and frequently includes collection of income and payment of taxes. Related services comprise "reporting services", which comprise the provision to clients and their investment managers with regular reports on their portfolios, including prices, gross and net asset values, and realized and unrealized valuation gains, as well as performance measures of investment managers. Providers of custody and related services generally keep their records quite distinct from providers of investment management services, even when these services are offered by the same institution. For most countries, though not all, transactions are settled by the custodian through a central securities depository (which provides safekeeping services on behalf of the issuer). In some cases, the provision of custody, settlement, and depository services are combined (as is the case with Euroclear). Most custodians will classify clients as resident or nonresident and whether they are taxable or tax-exempt. For nonresidents, the custodian can be expected to be familiar with the client's legal domicile, with relevant tax treaties, and with the market value of securities held on the client's behalf. However, custodians are not always in a position to determine whether a client is the beneficial owner of the security or an intermediary (such as another custodian or an investment manager) acting on behalf of the beneficial owner.

B. Custodian Chains

10. The emergence of custodian chains is partly a consequence of the globalization of financial markets and investor preference for diversified portfolios. A client may purchase securities issued in various countries and place these for custody with either a resident or nonresident “primary” custodian (i.e., the first link in the custodian chain). In turn, when these securities are sold, to complete the settlement, the primary custodian may use the services of sub-custodians resident in the countries where the securities are issued. It is also possible that the first link in the custodian chain is not a primary custodian but an investment manager, who may bundle accounts when using the services of a local custodian.

11. Because back-office custody services are a low value-added high volume business with a heavy capital requirement in support of electronic trading systems, there has been a high degree of concentration in the sub-custodian industry in recent years. As a result, some sub-custodians specialize in the provision of back-office services, while others have evolved into global custodians providing a range of back-office and related services as well as investment management services to clients with global portfolios.¹

C. Global Custodians

12. Successful global custodians have had to invest still more substantially in information technology in recent years in support of all their operations as well as maintain a global network of offices in the main financial centers. Their client base mainly comprises institutional investors with global portfolios and, more recently, high wealth individuals with global portfolios. The records on clients kept by global custodians depends on the business models they follow, which can vary considerably. A global custodian with a very centralized operation involving one profit center would probably compile a consolidated financial statement across its offices worldwide and in addition keep track of the accounts of each overseas branch. In such a business model, the head office could identify within its global operation the branch in which the beneficial owner maintains an account, and thereby provide information on the beneficial owner’s country of residence and institutional sector. Other global custodians may follow a more decentralized approach in which there are many profit centers, and for which less detailed records are required at the head office. This has implications for the ability of global custodians to provide useful information across their global operations relevant to third party reporting.

¹ As listed by the Financial Times, the largest global custodians comprise six U.S. custodians (Bank of New York, State Street, Morgan Chase, Citibank, Mellon Trust, and Northern Trust), two Swiss custodians (Credit Suisse and UBS) and one German custodian (Deutschebank).

D. High Wealth Individuals

13. For high wealth individuals (usually defined as individuals with portfolios of over \$1 million), the bulk of their portfolio holdings are believed to be with global custodians. This partly reflects the way in which some global custodians have specialized in the provision of investment management and custody services for this market, and the preference of high wealth individuals for the services of nonresident custodians. One consequence is that global custodians are a potentially useful third party data source for securities held by the household sector with nonresident custodians.

III. OUTLINE OF A PILOT THIRD PARTY CUSTODIAN STUDY

A. Who Should Participate

14. One feature of a third party survey is that the benefits and costs from participation are not evenly spread across countries. A consequence of this is that some countries that have specialized in providing custodian and related services to nonresidents may not wish to participate. Ideally, the pilot survey should target, as a core group, the countries that comprise the major global financial markets and other countries that specialize in the provision of investment management and custody and related services to nonresidents. This would comprise member countries of the EU, Japan, the U.K. and the U.S., together with Switzerland and the major offshore financial centers. However, although it may be the case that the major offshore financial centers and Switzerland would not wish to participate, it may still be worthwhile to conduct a pilot survey comprising the EU member countries Japan, the U.K. and the U.S. In any event, invitations to participate in the pilot survey would be sent to all countries participating in the CPIS.

B. What Information to Collect

15. The pilot survey would be in two parts. The first part would aim to increase our knowledge of the business models and information systems that support them that are used by custodians in the participating countries. This first part would be undertaken in countries where custodians have not already been approached. The survey would include global custodians and securities depositories. For global custodians, the survey would try to determine the accounting practices and information systems for the global as well as national operations. The second part would be completed by those custodians whose responses indicated that they hold securities directly for nonresident individuals. It would ask for information on the aggregate value of these holdings at a reference date together with a breakdown by the country of residence of the holder and the country of residence of the issuer of the security.

16. Depending on their responses to the first part of the survey regarding their business models and information systems, global custodians may be asked to report information on securities held on behalf of nonresident individuals in their overseas branches. Thus,

information on the aggregate value of securities held on behalf of nonresident individuals would be cross-classified according to the country of residence of the branch holding the security.

17. For the U.S. and possibly some other countries, custodians may be faced with a significant reporting burden if they are required to conduct a portfolio asset survey, a portfolio investment liability survey, and a narrowly defined third party survey (nonresident securities held on behalf of nonresidents) all for the same reference date. The exact mechanism under which this survey may be carried may vary from country to country. May involve the use of a statistical model (to adjust for timing differences, for example). Should this be the case, the narrowly defined third party survey and the portfolio investment liability survey could be conducted for a different reference date from the portfolio investment asset survey, and a statistical model used to bring the results to a common reference date.

18. It should be acknowledged that many countries do not have legal authority to conduct a narrowly defined third party survey, as their legal authority is confined to reporting transactions or holdings by residents. Ways of addressing this problem could be reviewed once it was established from a voluntary pilot survey that there is significant potential benefit to the CPIS from introducing third party reporting.

19. The results of the pilot survey would be reported to the 2003 meeting of the Committee.

IV. RECOMMENDATIONS TO THE COMMITTEE

- *That the Committee endorses the Fund's proposal to conduct a pilot survey among interested CPIS participating countries to determine the feasibility of collecting data on securities held by non-resident individuals according to their country of residence and the country of residence of the issuer, and to collect information on the size of such holdings. If this proposal is endorsed, volunteers from the Committee to participate in the pilot survey would be welcome. This would presumably include countries that have already established, or are establishing, custodian reporting for the CPIS.*