THE ROLE OF CUSTODIAL SERVICES OFFERED BY BANKS IN THE
SETTLEMENTS AND MANAGEMENT OF PENSION FUNDS

BY

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UNITED STATES INTERNATIONAL UNIVERSITY

SUMMER 2014
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A Project Report Submitted to the Chandaria School of Business in Fulfillment of the Requirement for the Degree of Master of Business Administration (MBA)

UNITED STATES INTERNATIONAL UNIVERSITY

SUMMER 2014
STUDENT’S DECLARATION

I, the undersigned, declare that this is my original work and has not been submitted to any other college, institution or university other than the United States International University in Nairobi for academic credit.

Signed: ______________________  Date: ______________________

Georgina Kyalo (ID.No.635897)

This project has been presented for examination with my approval as the appointed supervisor.

Signed: ______________________  Date: ______________________

Dr. Amos Njuguna

Signed: ______________________  Date: ______________________

Dean, Chandaria School of Business
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ABSTRACT

The purpose of this study was to establish the role of custodial services offered by banks in the settlements and management of pension funds by focusing on commercial banks in Kenya. The study also sought to establish the financial assets under custody in commercial banks in Kenya; to determine the challenges facing custodial services offered by banks in the settlements and management of pension funds; and to determine strategies that can be used to improve custodial services in commercial banks in Kenya.

Descriptive research design was applied on 12 commercial banks in Kenya that offer custodial services to pension funds. The target population of this study was therefore 177 staffs. Stratified random sampling was used to select 53 respondents. Data was collected by use of questionnaires. Content analysis was used in processing of qualitative data while descriptive statistics were used to analyze quantitative data, which was then presented in tables and figures (bar charts and pie charts). Statistical inferences were drawn by use of correlation analysis.

The study established that custodial assets in the 12 commercial banks in Kenya include shares, provident funds and trust funds, bonds, treasury bonds, pension funds, insurance funds and commodities such as precious metals and currency (cash). In addition, some banks offer custodial services for treasury bills, land/real estates, title deeds, corporate bonds, commercial papers, offshore investment, unit trusts, money market investments and Escrow funds.

In relation to challenges facing custodial services offered by banks, the study established that that globalization of financial markets, increasing complexity and diversity, increasing technology, competition in cross border access and competition from CSDs and risks incurred by both custodians and custody clients. Other challenges include late clients' instructions, challenges relating to inefficient players like other banks lack of market specific technologies and lack of skills within the market. It was also revealed that most banks use frequent audits and constant operational risks review, regular staff training and updates and standardization of process to deal with risks and challenges. In addition, commercial banks do follow-ups on queries and solving them in due time.
The study recommends that commercial banks in Kenya should improve their technology so as to deal with increasing complexity and diversity in the industry. In addition, commercial banks in Kenya should come up with better marketing strategies and promotions so as to attract more customers. To deal with various types of risks, commercial banks should ensure frequent audits, constant operational risks review, regular staff training and updates and standardization of process. In addition, commercial banks do follow-ups on queries and solving them in due time. The study further recommends that commercial banks in Kenya should ensure trade compliance, regular stakeholder’s involvement, improve staffing and improve governance.

To improve their custodial services commercial banks in Kenya should improve their technology so as to deal with increasing complexity and diversity in the industry. Commercial banks should also ensure frequent audits, constant operational risks review, regular staff training and updates and standardization of process. In addition, commercial banks do follow-ups on queries and solving them in due time.
ACKNOWLEDGEMENT

First of all I extend my gratitude to the Almighty God for providing me with strength, knowledge and vitality that helped make this project a reality.

To my dear parents, words cannot express my gratitude for all the priceless treasures you have freely imparted in my life, one being the importance of education. I appreciate the sacrifices you willingly made to ensure that I become an empowered woman and a lighthouse in my generation. I owe a great deal of gratitude to my family members for their unfailing moral support throughout my period of study and for understanding and appreciating the demand of the course in terms of time and resources.

I cannot forget my class mates who have been a source of inspiration throughout my study and for assisting me in sourcing for information and materials for this proposal. I acknowledge with gratitude my supervisor, whose patience, guidance, encouragement, suggestions and constructive criticisms were instrumental in the success of this proposal. To the lecturers of USIU who taught me, I am very thankful.
DEDICATION

I dedicate this work to my family for their understanding and support during my period of study. To my parents, my sisters and brothers for their love, care, concern, support, encouragement and enthusiasm inspired me to achieve this goal.
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LIST OF ABBREVIATIONS

CSDs: Central Securities Depositories
DTC: Depository Trust Company
ECB: European Central Bank
ECSDA: European Central Securities Depositories Association
EU: European Union
GDP: Gross Domestic Product
GPIF: Government Pension Investment Fund
NSSF: National Social Security Fund
PWC: PriceWaterhouse Coopers
RBA: Retirement Benefit Authority
SEC: Securities and Exchange Commission
STP: Straight-Through Processing
UK: United Kingdom
US: United States
CHAPTER ONE

1.0 INTRODUCTION

1.1 Background of the Problem

Custody is a service in which a fiscal institution takes hold of securities on behalf of the client. In the times when securities existed only in paper form, investors required a secure place to keep these certificates of value (Yang & Mitchell, 2005). That secure place could either be a clients own premises, or that of a security service provider. Currently, custody is offered by a range of institutions, chiefly by brokers, commercial banks and investment banks. These providers have developed particular services that accommodate diverse customer segments (Bikker & Dreu, 2009). Today, a lot of attention is attached to effectiveness of technology application, the efficient processing of transactions and the ability to gather assets. Services typically offered by banks are safekeeping, settlement and the reporting of the customers’ securities and even cash. These services are targeted to a variety of customers such as agency and fiduciary accounts, retirement plans and insurance companies.

As shown, banks were the usual providers of physical safekeeping services, for they would typically have strong vault for the holding of money and other treasures taken for deposit (Stewart & Yermo, 2009). The custodian bank was enabled to provide additional services linked to settlement and asset servicing, by having the physical securities in safekeeping. Even though, custodian banks’ main function at the moment is no longer safekeeping of physical securities, the extent of their services in settlement and asset servicing continues being relatively unchanged. When securities are bought by a client or even sold to him, the custodian takes heed of the delivery and receipt of securities alongside the agreed sum of money (Stewart, 2009). This process of trading of securities against cash is usually called settlement.

Alternatively, holding securities in an investor’s portfolio creates a center of attention to services such as benefits, rights and obligations. The services offered by the custodian make sure that the investor gets that which he is entitled. They services habitually fall into numerous wide groupings, which comprise of collection of dividends as well as interest, corporate measures such as rights matters, re-denominations or business reorganizations,
payment and/or reclaim of tax along with voting at shareholders’ meetings via proxy (Nathan, 2006).

According to Vlaar (2005) a good deal of the work done in asset servicing, involves a custodian acting as an information intermediary, communicating between issuers and securities holders. While the investing customer could have executed the allied work itself, it is more expedient for it to delegate these actions to a professional. Custodian institutions have developed economies of scale to make available services to their clients at a price that is fewer than what the client would spend, and possibly faster and with less operational blunders than if the client were to do the same work itself (Kentouris, 2011). In every market, there are generally a number of local custodian banks that offer custody services, thus giving clients a choice of services and costs. When banks offer custody services in several markets through a single service agreement with clients, they are called global custodian banks (Tilba & McNulty, 2013).

The provision of custodial services is typically decided by the multi-tiered intermediation, market volume, and the market formation. Conversely, the demand for the custody services is more often than not determined by investors as well as intermediaries to investors (Njuguna & Arnolds, 2012). Mostly, retail investors use the similar intermediaries (custodians) to acquire and sell securities. Nevertheless, retail investors’ needs are more restricted in terms of verification of dealings, asset servicing, and monthly statements as contrasted to investment firms (Van Rooij, Siegmann & Vlaar, 2004).

Pension funds contribute directly as well as indirectly to the economic expansion of countries worldwide through their contribution to the GDP, accretion of savings, financial market improvement, reducing old-age poverty and acting as clients of financial services in addition to being the main spring of income for the aged population. Internal inefficiencies however, lead to high expenses of operation, low retirement proceeds, reduced returns on investment and in extreme cases to the termination of the funds (Kochen, 2006).

The United Nations approximates that by 2050, there will be roughly 2 billion people over 60 worldwide and close to 80% of them will be living in developing nations. According to Stewart and Yermo (2009), the number of older people in Africa is anticipated to develop by 50% between 2000 and 2015. It is also projected that 20% of
the world's poorest survive on less than one dollar per day and they are over 60.5% of the population. These older citizens are very reliant on income from their pension funds.

Pension fund managements require being efficient, because they have managerial responsibilities, make decisions concerning entitlements and benefits, and ensure that the long-term requirement are met in the context of risk and doubt (Fishwick & Bernard, 2012). This imply that pension funds are like other business organizations in that they have goals and objectives to be comprehended and so their competence can be assessed on the basis of their capability to achieve these objectives. The major challenge lies in the recognition and execution of the best practices to enhance operational and financial effectiveness, since pension funds promise long-term returns to the investors and invest over 90% of their funds in unpredictable financial markets (Amery, 2012).

1.1.1 Custodial Services in Commercial Banks in Kenya

In Kenya, various commercial banks in Kenya have ventured in offering custodial services. Under custody commercial banks in Kenya carry out settlements, safekeeping, corporate actions (e.g. bonus issues, rights issues), registration, proxy voting, tax reclamation, income collection, valuation, reporting, inward and outward remittances, foreign exchange conversion and cash management (Nathan, 2006).

The retirement benefits authority has registered 12 commercial banks to settle and manage pension funds. The pension industry in Kenya grew 4.4 per cent to stand at Kshs470.6 billion ($5.54 billion) as at June 2011, with Kshs113.5 billion held by NSSF, Kshs326.9 billion ($3.85 billion) by fund managers and Kshs30.2 billion ($355.3 million) in property investments not controlled by fund managers (RBA, 2014).

As at December 2011, however, pension managers lost Kshs17 billion ($200 million), the first drop since industry regulator Retirements Benefits Authority was started in 2002. The contraction was as a result of the drop in the value of pensions assets from Kshs420 billion ($4.941 billion) in December 2010 to Kshs403 ($4,741 billion) in December 2011. The drop was caused by the lowered earnings of equity investments at the Nairobi Securities Exchange and the steep rise in interest rates which devalued government securities held by fund managers.
The industry’s average return on investment dropped to negative 9.9 per cent. In the year 2009, the return stood at negative 4.28 per cent. The industry comprises of the dominant NSSF, 1,077 registered schemes, 23 registered individual schemes, 64 unregistered individual schemes, the Civil Service pension scheme, 16 fund managers, 26 administrators, 12 custodians and six actuarial service providers. Fifteen per cent of the working population in Kenya is covered by the schemes, with NSSF taking 67 per cent, the Civil Service scheme 22 per cent, private schemes 10 per cent and individual schemes one per cent (RBA, 2014).

1.2 Statement of the Problem

Custody business originated from settlement and safekeeping services offered to customers for a fee. Initially, banks settled trades and also processed their own investments. The customers had to clip coupons and take their securities out of the safekeeping to settle trades. Banks identified an opportunity in that their expertise in security could be valuable to consumers. To date, the custody industry has grown widely. The role of custodians has been significant in offering expertise for several assets and consolidating holdings.

Custodians as well as users of custody services face various risks which can be classified into operational, legal and financial risks (Mutero, 2011). Custody services offered by banks in Kenya are under the supervision of banking authorities, which focus on financial risk management, capital adequacy and operational risk mitigation. These custody services include settlement, safekeeping and reporting settlements, corporate actions like bonus issues and rights issues, registration, proxy voting, tax reclamation, valuation, inward and outward remittances, foreign exchange conversion as well as cash management (Rono, Bitok & Asamoah, 2010). These services are available to institutional investors as well as to individuals. The most common clients of custodial services in commercial banks in Kenya include staff retirement benefits schemes like pension funds.

Various studies have been conducted in the custody industry. For instance Chan et al. (2007) conducted a study on the securities custody industry, Fodder (2011) conducted a study on the future of custody, Fors and Norén (2009) did a study on the future of the
Nordic custody industry and Cox (2008) did a study on the custody industry runs to keep pace. However, there is no empirical evidence showing the role of custodial services offered by banks in the settlements and management of funds. This is despite the high growth of the industry and the challenges facing the settlement and management of pension funds. This study will therefore seek to provide ways that can be used to enhance settlement and management of pension funds in banks.

1.3 General Objective

The general objective of this study was to establish the role of custodial services offered by banks in the settlements and management of pension funds in Kenya.

1.4 Specific Objectives

The specific objectives of this study were:

1.4.1 To establish the financial assets under custody in commercial banks in Kenya
1.4.2 To determine the challenges facing custodial services offered by banks in the settlements and management of pension funds
1.4.3 To determine strategies that can be used to improve custodial services in commercial banks in Kenya

1.5 Importance of the Study

This study is of great importance to the management of commercial banks in Kenya, researchers and academicians, the government of Kenya and policymakers.

1.5.1 Management of Commercial Banks in Kenya

To the management of commercial banks in Kenya, this study will provide information on how custodial services influence the settlements and management of pension funds. The study will also make recommendations on whether it is beneficial for commercial banks in Kenya to venture in the settlements and management of pension funds.

1.5.2 Researchers and Academicians

To the academicians and researchers the study will be of great importance since as it provides a good literature review on the role of custodial services offered by banks in the settlements and management of pension funds. It is an academic resource to append to the
existing gap between custodial services and settlement and management of pension funds. To the general academic fraternity the study forms a base for further studies on the role of custodial services offered by banks in the settlements and management of pension funds can be carried out.

1.5.3 The Government of Kenya and Policymakers

The study is also of great importance to the government of Kenya as it provides information on the role of custodial services offered by banks in the settlements and management of pension funds which can be used to formulate policies on the settlements and management of pension funds.

1.6 Scope of the Study

This research study focused on all commercial banks in Kenya that offer custodial services. The study was limited to the custodial services department in commercial banks. Further, the study used a descriptive design. In addition, questionnaires were used to collect data to answer the research questions. The data was collected in May 2014.

1.7 Definition of Terms

1.7.1 Custodian: A financial institution that holds customers' securities for safekeeping so as to minimize the risk of their theft or loss.

1.7.2 Pension Funds: A fund established by an employer to facilitate and organize the investment of employees' retirement funds contributed by the employer and employees.

1.7.3 Custody: The protective care or guardianship of someone or something.

1.7.4 Management: The organization and coordination of the activities of a business in order to achieve defined objectives.

1.7.5 Settlement: A formal agreement or decision that ends an argument or dispute

1.8 Chapter Summary

This chapter presented the background information, statement of the problem, objectives of the study, scope of the study, importance of the study and definition of terms. This study seeks to establish the role of custodial services offered by banks in the settlements
and management of pension funds in Kenya. The study is of great importance to the
government of Kenya, the academic fraternity, and to commercial banks in Kenya. 
Chapter two focuses on the review of literature in relation to the themes of the study.
Chapter three provides the research methodology, Chapter four presents the results and findings of the study and Chapter 5 presents discussion of the findings, conclusions, and recommendations for practice and further research on the problem.
CHAPTER TWO

2.0 LITERATURE REVIEW

2.1 Introduction

This chapter discusses the literature on custodial services offered by financial institutions in the settlements and management of pension funds globally. It goes further to give a comprehensive discussion on the different types of the custodial assets in the custodial industry not to mention the challenges facing the services offered by banks. The chapter also outlines various strategies that can be considered so as to improve the custodial services.

2.2 Custodial Assets

2.2.1 Shares

Shares are one of the custodian assets in various types of custodians worldwide. According to Lapavitsas et al (2010) a share is an entity of account for a range of financial instruments including stocks and investments in restricted partnerships, along with real estate investment trusts. The regular feature of all these is equity participation (restricted in the case of preference shares). A corporation divides its assets into shares, which are presented for trade to raise capital, termed as issuing shares. Thus, a share is an inseparable unit of capital, expressing the contractual affiliation between the company and the shareholder. The denominated worth of a share is its face value: the total capital of a company is divided into a number of shares A custody-only trading is a scheme in which shares must be recorded to the holder by name and can only be traded in physical form. The implementation of custody-only trading entails any purchases or transfers of stock to be positioned through the issuing company's transfer agent. The transfer agent terminates the shares received from the broker, and issues a new share certificate for an equivalent quantity of shares to the customer. While custody-only trading is a burdensome process, some companies implement it to contradict "naked" short selling (Todd, 2014).
2.2.2 Corporate Bonds

Bonds are also custody assets. Bonds are granted by public establishments, credit institutions, companies as well as supranational organizations in the major markets. The most prevalent method for issuing bonds is through underwriting. When a bond issue is underwritten, one or more securities firms or banks, forming a syndicate, purchase the whole issue of bonds from the issuer and re-sell them to investors (Bigger & Bigger, 2010). The security firm takes the risk of being not capable to sell on the issue to end investors. Primary issuance is set by book runners who organize the bond issue, have direct contact with investors, and operate as advisers to the bond issuer in terms of timing and value of the bond issue. The book runner is listed first amongst all underwriters taking part in the issuance in the gravestone ads normally used to advertise bonds to the public. The book runners' readiness to underwrite must be discussed aforementioned to any conclusion on the terms of the bond issue, since there may be limited demand for the bonds (Dierick et al., 2005).

Bond is an instrument of gratitude of the bond issuer towards the holders. It is a debt security, under which the issuer owe the holders a debt and, depending on the stipulations of the bond, is obliged to pay them interest and/or to pay back the principal at a future date, termed the maturity date (Yang & Mitchell, 2005). Interest is more often than not payable at fixed intervals (semiannual, annual, and sometimes monthly). Very frequently the bond is open to discussion, i.e. the ownership of the instrument can be transferred in the secondary market. This means that on the occasion that the transfer agents at the bank medallion stamp the bond on the second market, the bond is extremely liquid (Bindseil & Papadia, 2006).

2.2.3 Treasury Bonds

Treasury bonds are as well thought-out as custody assets. A treasury bond is a bond issued by a state government, commonly with an assurance to pay periodic interest payments plus to repay the face value on the maturity date. Treasury bonds are frequently denominated in the country's own currency. Treasury bonds are issued by national governments in foreign currencies are usually referred to as sovereign bonds, even though the word sovereign bond may as well refer to bonds issued in a country's own currency (Burton, 2013).
The conditions on which a government can sell bonds depend on how creditworthy the market deems it to be. Worldwide credit rating agencies will offer ratings for the bonds, but market participants will decide on their own about this (Vlaar, 2005). Treasury bonds in a country's own currency are occasionally taken as an estimate of the hypothetical risk-free bond, since it is assumed that the government can raise taxes or make additional currency so as to redeem the bond at maturity. There have been occurrences where a government has defaulted on its domestic currency debt, for instance Russia in 1998 the ruble crisis (Cox, 2008).

2.2.4 Precious Metal

Riley (2006) defines a precious metal as an uncommon, naturally occurring metallic chemical element of high economic worth. Chemically, the precious metals are less reactive than a majority of elements. They are usually supple and have a high lustre. Traditionally, precious metals were significant as currency but are now considered largely as investment and industrial commodities. The most common precious metals under custodians include gold, silver; coinage metals, platinum, and palladium each have an ISO 4217 currency code. The demand for precious metals is driven not only by their practical use but also by their role as investments and a store of value. Historically, precious metals have commanded much elevated prices than common industrial metals (Rudroff, 2009).

Gold and silver, and sometimes other precious metals are often seen as hedges against both inflation and economic downturn. Silver coins have become popular with collectors due to their relative affordability, and, unlike most gold and platinum issues which are valued based upon the markets, silver issues are more often valued as collectables, far higher than their actual bullion value (Stanley, 2004).

2.3.5 Pension Fund

In various countries, globally, pension funds are administered and settled by custodians like banks. According to Giarraputo (2005), a pension fund is any plan, fund, or scheme which provides retirement income. Pension funds are important to shareholders of listed and private companies. They are especially important to the stock market where large institutional investors dominate (Fodder, 2011). The largest 300 pension funds
collectively hold about $6 trillion in assets. In January 2008, The Economist reported that Morgan Stanley estimates that pension funds worldwide hold over US$20 trillion in assets, the largest for any category of investor ahead of mutual funds, insurance companies, currency reserves, sovereign wealth funds, hedge funds, or private equity. Although the (Japan) Government Pension Investment Fund (GPIF) lost 0.25 percent, in the year ended March 31, 2011 GPIF was still the world's largest public pension fund which oversees 114 trillion Yen ($1.5 trillion).

2.2.6 Provident Fund

According to Tilba and McNulty (2013) provident fund particulars vary widely by country, but in general their purpose is to provide financial support for those who meet the plan’s defined retirement age. Governments set the age limit at which withdrawals are allowed to begin (penalty-free), though some pre-retirement withdrawals may be allowed under special circumstances, such as for medical emergencies. In Swaziland, for example, provident fund benefits can be claimed as early as age 45. Each provident fund sets its own minimum contribution level for workers and employers, which may vary depending on the worker’s age. Some funds allow individuals to contribute extra to their benefit accounts and allow employers to contribute extra for their employees (Lim, 2013).

If a worker dies before receiving benefits, his or her surviving spouse and children may be able to receive survivors' benefits from the provident fund. Some countries also allow individuals to receive an early payout if they emigrate to another country. Those who work past the minimum retirement age may face restricted withdrawals until full retirement (Fodder, 2011).

2.2.7 Insurance Funds

Insurance is the equitable transfer of the threat of a loss, from one entity to another in exchange for payment. It is a form of risk management primarily used to hedge against the risk of a contingent, uncertain loss (Giarraputo, 2005).

To further strengthen risk control and continuously improve the risk management level of custody business, Bank of pays attention to the international advanced risk management concepts and methods and applies them into the custody business practice, emphases internal control and straight-through processing(STP), implements the risk window
forward shift, and takes the lead in the same industry to employ KPMG, PWC, EYGL and other internationally renowned accounting firms to regularly make special assessment on custody business internal control and reliability of custody system, to fully ensure the safety and soundness of custody business (Stanley, 2004).

2.2.8 Trust Fund

This is a financial service where the custodian bank is commended by trust company to safeguard the trusted assets, covering settlement, asset valuation, accounts checking, trading supervision and information disclosure. Trusted assets under custody can be securities investment, equity investment or financing, depending on the investment target (Briotti, 2005).

Third party custody is a long-term mechanism to achieve steady progress. The system of checks and balances separates the three rights (ownership, management, supervision) on the trusted asset and improves governance structure, reliability of trusted products, public confidence on trust companies and industry. According to Garbaravicius and Dierick (2005) the progress in securities investment funds has proved the important role played by this mechanism. To introduce third party custody can enhance operation efficiency, reduce operating cost, and achieve information transparency of trusteeship project. This helps the internal control standards for trust service, day-to-day external supervision, separation of external and internal risk, and timely risk tips (Fors & Norén, 2009).

2.3 Challenges Facing Custodial Services Offered by Banks

2.3.1 Increasing Complexity and Diversity of Assets

As indicated by Lim (2013) the main forces that are most likely to shape the custody industry in the years to come comprise the continued globalization of the financial markets, leading to changes in the investment patterns of institutional investors and increased demand for global liquidity management solutions. The rivalry for superior investment returns and the increasing allocation of institutional investment portfolios to alternative investments e.g. derivatives, hedge funds, commodities – will require custodians to increase a variety of new and specialized services for these alternatives. The different providers in the custody industry will be impacted in different ways. Because of keen competition that has resulted in progressively lower price levels, custodians of all
types are faced with the challenge of revenue compression concurrent with a need to invest (Fodder, 2011).

One major challenge facing global custodians is how to keep up with their institutional investor clients’ wider alternative of investment assets and the associated specialized service requirements. Financial market innovations and globalization increase the variety and frequently the complexity of financial instruments that institutional investors choose to buy. Derivatives and hedge funds, for example, have become relatively ordinary in institutionally managed portfolios (Stanley, 2004).

In the US, the need for consistent high investment volumes and economies of scale has led to the strengthening of the global custodian industry. Due to this, there are is a small number of relatively stable large global custodians and a number of them have done some specializations. Most niche providers are premium-priced, have value added services offered to a particular customer segment and have the capability to provide more customized and flexible services that most large custodians experience some difficulties delivering (Rudroff, 2009). In addition, mergers and acquisitions are taking place in the global industry. For instance, two of the largest United states global custodians, known as State Street and The Bank of New York of late combined with medium-sized firms like Investors Financial Services Corporation and Mellon Group respectively. In Europe, the custody business is structured differently from the United States and is specifically characterized by little or no specialization. Certainly, a large segment of the custody industry is embedded in parts of universal banks and non-specific business units (Fodder, 2011).

In the future, the European custodians may face an increased competition from the United States custodians as they move out looking for more customers. The market in the United states is mature and the United States custodians are depending on the European market to make sure that their future development is secure.

2.3.2 Increased Technology

Global custodians require investing not only in technology, processing, and report on these new asset types, but they also need to implement additional operational risk controls. A large global custodian might typically spend several hundred million euros a year on information technology. A global custodian needs to make efficient technology
investments so it can reap first-mover benefits from new value added services (Rudroff, 2009). He says that unless the first-mover advantage is sufficiently sustainable, however, competition could erode the premium pricing before the investments yield a significant return. Followers need to invest in technology in order to stay competitive and stay in business. Price competition is keen, since scale economies are important in an industry characterized by high fixed technology costs and relatively low marginal costs for servicing incremental business volumes.

2.3.3 Competition from CSDS in Banking Services

Some CSDs, in particular those with banking permits, compete with custodian banks in services that involve credit risk taking, such as liquidity provision for settlement, securities financing and collateral management (Riley, 2006). A CSD that has control over the settlement process for an entire market is in a unique position to integrate core infrastructure services, and banking services seamlessly even on the same processing platform. Custodian banks would find it difficult to match the economies of scale of a market infrastructure (even more difficult if it is a multi-market infrastructure), and could not match the efficiency level of market infrastructures, especially if the value added services are run on the CSD’s platform, as none of them would have a client base that includes all participants in the market. Services such as securities financing and collateral management benefit from the network effects of a CSD, whose clients include both investors with assets and brokers who need to borrow them (Stanley, 2004).

CSDs that offer securities financing services can disinter mediate banks as the ease and convenience of bundled core settlement and securities financing services are especially attractive to investment banks which are heavy users of these services. This could lead ultimately to a reduction of choice and bargaining power of other categories of users, to their detriment. Giving custodians equal access to compete effectively in the provision of banking services could help lower the cost to market participants and increase their negotiating power for better service. Indeed, keen competition at the intermediary level is the mechanism by which reductions in running costs are passed through to the user (Lim, 2013).
2.3.4 Risks Incurred by Custodians

The risks acquired by custodians may arise in the situation of their provision of custody services, linked with specific activities and particular consequences. However, these are the same kinds of risks that a bank generally faces, manages and alleviate for all banking services. Essentially, there are no additional groups of risks that are unique to a bank’s custody service (Riley, 2006).

Operational risk is the risk of financial loss resulting from inadequate or failed internal processes, people or systems, or from external events. It also includes the risk of failure to comply with applicable regulations, contractual agreements and a firm’s own policies. It is not possible to catalogue all types of operational risk exhaustively, but some common examples arising from custody services include corporate actions, settlement, fund accounting and administration, risk mitigation techniques and standard practices (Bindseil & Papadia, 2006). Bindseil and Papadia (2006) defined a corporate action as an event initiated by a security insurer, giving rise to a right in favor of investors. In relation to operational risks, the entire value of an action could be at stake due to the operational risks are associated with corporate actions, where the whole value of an action could be at stake due to errors in operation or a lack of follow-up and, tracking. In addition, failure to meet a deadline for the exercise of a right can lead to loss of the value of the entire business. Further, an incorrect client account setup and maintenance can, result into crediting entries to the wrong accounts, or applying incorrect withholding tax on income, and could even increase the fraud possibility.

Credit risk is the risk that the client will not be able to meet its financial obligation to the custodian, for example due to insolvency. Since the purchase, sale and holding of securities involve payments, custodian banks not only process payments but also extend credit and provide liquidity to clients (Dierick et al., 2005). A custodian bank may lend money to the client for the settlement of securities purchases, or may advance money to clients on the due date of interest or dividend payments when the money has not yet been received from the issuer of the securities. A custodian bank may also provide intraday liquidity to clients by making payment to a client’s counterparties early in the day before the expected funds for credit to the client’s account arrive later that day. If the funds do
not arrive as expected, the funds are lent overnight to the client by the custodian bank (Stewart & Yermo, 2009).

Legal risk is commonly defined as the risk of a loss of a right resulting from laws and regulations being inapplicable or unenforceable or other legal circumstances, e.g. inadequate laws, inadequate legal documentation. Regarding custody, one of the most important and likely legal risks among rights in securities surrounds the contestability of rights over collateral (Bigger & Bigger, 2010).

The nature of securities services is such that if a bank lends on a collateralized basis, the collateral is predominantly provided in the form of securities. The risk of inapplicability of the preferred choice of laws governing the collateral agreement is particularly increased in the cross border context, where the conflict between national laws is, in general, the major source of uncertainty (Lapavitsas et al., 2010). When a custodian needs to liquidate collateral used to secure a loan to a client, if the collateral was provided cross-border or the underlying securities are multinational, several national jurisdictions could be involved, affecting the custodian’s right to liquidate the collateral, and possibly resulting at least in a delay or even complete unenforceability in the absence of adequate due diligence (but even in case of due diligence, delays may occur as a result of inadequate collateral laws) (Stewart & Yermo, 2009).

2.3.5 Risks Incurred by Custody Clients

Custodians’ customers are exposed to operational, financial and legal risk from their service provider. In some jurisdictions, regulations require institutional investors such as pension funds to exercise due diligence when selecting custodians, so as not to subject fund holders and final beneficiaries to losses that could be caused by an operationally inadequate or financially unsound custodian. Operational, financial and legal risks incurred by clients of custody services are incurred in other banking services as well (Petschnigg, 2005).

A custodian that has weak operational controls and continuity of business arrangements could make errors or incur delays in processing corporate actions, settlement and fund administration that cause financial loss to its clients. The custody agreement would normally provide for client compensation if the fault is the custodian’s, but such
provisions generally do not cover consequential damage, which could be a real and significant financial loss (Todd, 2014). Consequential damages include “opportunity costs”, losses incurred due to missed hypothetical but likely business opportunities that are un-substantiable. In addition, a client needs to evaluate the financial health of a custodian bank prior to its appointment and monitor it during the course of the service contract (Rono, Bitok & Asamoah, 2010). All cash deposited with a bank represents a client’s exposure to that bank. Financial market participants and consumers rely on public authorities’ oversight and supervision of banks to ensure that banks are prudently managed and remain solvent. Clients should resist moral hazard where the belief in a bank being “too big to fail” might lead them to have an imprudent tolerance of financially unsound banking practices (Dierick et al., 2005).

The main legal risk for clients of custodian banks is the risk of loss of title to securities (including shortfalls) held in its account. A custody agreement is one in which a client entrusts securities and the related servicing to a custodian. The main legal risk is therefore the ability of the client to ensure that its rights are protected from any unauthorised use by the custodian, as well as against third parties or bankruptcy of the custodian (Bindseil & Papadia, 2006).

According to custodians, internalized settlement is no more risky than settlement in a CSD. As a standard practice, custodians ensure that two customers that transact have sufficient securities and cash respectively before effecting the transfer, thereby ensuring that a customer is not exposed to the risk of loss of principal. Following this practice, therefore, ensures that internalized settlement is no more risky than settlement in a CSD regarding protection from principal risk (Cox, 2008).

2.4 Strategies that can be used to Improve Custodial Services

2.4.1 Improvement of Governance

According to Riley (2006) demand from financial intermediaries in the banking sector, custody service has considerably expanded the variety of products and services available to them locally. It has become more and more obvious since the launch of the custody service just over a year ago that financial intermediaries fund administrators, trust companies, family offices, law firms, accounting firms, and liquidators are all demanding a strong service supplier with universal abilities.
In the current environment, character and immovability are also progressively more important. High net worth individuals, families and multinational companies all look for custodians that have a constructive global reputation and a strong name in the world of investment banking. In this respect, Deutsche Bank’s Tier 1 status and international character for custody solutions is playing an important function in attracting high quality custody business to the authority (Rudroff, 2009).

Investment banks engage in a range of activities in the securities market. Their trading strategy is normally very short term to medium term, and they turn around their securities portfolio very regularly. To ensure maximum flexibility, this client segment generally tries to be as close as possible to the market. Typically, they either contribute directly in a CSD or employ the services of a multi-direct custodian or single-market custodian (Giarraputo, 2005). One of their specific indispensable wants is liquidity. This is the capacity to conduct their securities activities in the most efficient way so as to minimize the need to scrounge funds, and when they do borrow to have access to funds at the lowest charges (Mongelli, 2005).

**2.4.2 Regulation by CBK**

Custodian banking services falls under the Kenyan financial division, particularly the commercial banks, which are synchronized under the banking act, retirement benefit act and the capital markets act. A custodian have to be licensed as a commercial bank by the central bank of Kenya, registered as a custodian with the retirement benefits authority and also registered with capital markets authority as an approved depository (Nathan, 2006). According to the retirement benefits act, 1997, a custodian means a company whose business includes taking the liability for the safe custody of the funds, securities, financial instrument and documents of title of the assets of scheme funds. The capital market act (Cap. 488) defines a “Custodian” as a bank licensed under the banking act or a financial institution approved by the capital market authority to hold in custody funds, securities, financial instruments or documents of title to assets registered in the name of local investors, east african investors, foreign investors or of an investment portfolio. The retirement benefits act and capital markets act recognizes custodian banks as one of the key government policy in mobilization of vast deposits which when invested will propel the economy by injecting professionalism, transparency, and accountability in the

2.4.3 Reduction of Various Risks

Providing custody services entails risks, but custodians’ clients also take risks on their service providers. The risks for both parties fall into three general categories: operational, financial and legal, although the nature of such risks and the conditions in which they crop up differ between the provider and the consumer of custody services (Fishwick & Bernard, 2012). In the wider context of financial market stability, there is also universal risk that can be caused by operational or financial failure of a custodian that is a large financial institution, but such risks are not specific to the provision of custody services (Mongelli, Dorrucci & Agur, 2005).

Most operational risks can be alleviated through a system of suitable and strict controls. Custodians spot the operational risks involved, develop and put in place controls, and always test, evaluate and monitor the competence and sufficiency of such controls. Under Basel II, custodian banks are required to self-assess the exposures related to operational risk and have sufficient capital to conceal potential losses. Custodians clients would be exposed to alike operational risks like regulatory constraints, if they were to execute the same services themselves in-house. To most clients, buying settlement services and back-office corporate actions from custodians has the effect of using custodians’ scale economies and skills reduce operational errors (Mongelli, Dorrucci & Agur, 2005).

Most banks globally are supervised and regulated as credit institutions and as such have processes and policies in place to control the quality of credit clients with whom they enter into custody agreements or conduct other banking business. In addition, processes are generally in place to recognize, for each client, the business activities for which the bank would extend credit, the extent of the exposure to each type of activity, whether credit is to be collateralized and the overall exposure limit to the client. The limits would characteristically be managed for all exposures, including intraday exposure. As the limit gets nearer, escalation procedures normally kick in to make sure appropriate risk management review and action are used (Nathan, 2006).
The legal risks rely on certainty on and within the applicable legal regime and the consistency between the custodian’s rights and its obligations on clients and CSDs. This cannot be directly controlled by the custodian. The best alleviation approach is a strong credit risk management and monitoring, and reducing exposure to clients who are not financially sound in the first place. At the public policy level, legal risk can be dealt with by creating clear and binding rules to deal with conflicting laws, or more efficiently through ordinary legislation, making the enforceability of contracts more reliable (Rono, Bitok & Asamoah, 2010).

Before appointing a custodian, the appointing institution should usually evaluate its operational robustness by use of requests for information and, at times, on-site visits to the center of operations. Controls and management quality is normally a considerable custodian selection criterion. The ongoing operational robustness assurance is also important. Some clients need that their custodians have third-party standardized control qualifications that are enforced (Kentouris, 2011).

Complications that results from the national laws interaction in a cross-border context that could lead to a loss of assets title cannot be avoided by an individual client, even though they can take basic safety measures like contractual terms that necessitate the custodian to have proper segregation of client assets and terms stipulating the obligations under the law regulating the bilateral contract between custodian and client (Stewart, 2009).

Custodial services offered by a bank fall under the regulation and supervision of the bank. There are widespread regulatory controls governing bank custodians, and in numerous markets specific requirements are imposed on the custody arrangements of institutional investors such as collective investment plans, which in turn inflict compliance necessities on their custodian banks (Chan et al., 2007). Custody services provided by other institutions such as investment firms are not necessarily subject to similar regulations. As mentioned earlier, CSDs are subject to specific regulations, resulting from their central market position (Briotti, 2005).


2.4.4 Improve Staffing

Competent management and suitable staffing are necessary to effective risk management. Experienced staff, adequate training, and the aptitude to manage turnover play a key role in a bank’s ability to offer high quality and steady performance in custody services (Amery, 2012). A bank must cautiously compare its custody staffing levels with the volume of business and the difficulty of the services offered. If staffing is not sufficient to handle the volume of business, transactions may be poorly executed, customer service may be inadequate, and the bank may lose both dollars and customers (Garbaravicius & Dierick, 2005).

2.4.5 Ensure Trade Compliance

The board and management are in charge for ensuring that a bank’s custody activities observe with applicable laws and regulations. All applicable laws and regulations pertinent to the custody business should be acknowledged and communicated to the suitable personnel. The custodian should have a system in place to monitor for compliance with applicable laws and regulations (Lim, 2013).

Chan et al., (2007) argue that some of the compliance issues that may crop up for custodians are compliance with local law, recordkeeping and substantiation requirements, shareholder communication, mutual fund custody, retirement plan assets, fiduciary actions, anti-money laundering, securities lending, and free-riding. An important part of any custodian's business approach is to provide its customers with recordkeeping and reporting services. The recordkeeping services should meet the customers’ specialized requirements and comply with applicable recordkeeping and reporting laws and regulations (Bikker & Dreu, 2009). Custodians should be able to produce customized customer reports as well as mandatory regulatory and legal reports (Giarraputo, 2005).

2.5 Chapter Summary

This chapter presents a review of literature in relation to the themes of the study. The chapter began with the development of the custody industry, custodian asset, and the challenges facing custodial services offered by banks, as well as strategies that can be used to improve custodial services. Chapter three provides the research methodology.
CHAPTER THREE

3.0 RESEARCH METHODOLOGY

3.1 Introduction

This chapter presents the methodology of the study. It outlines how the study was carried out. The chapter presents the research design, population and sampling design, data collection method, research procedures, data analysis method and chapter summary.

3.2 Research Design

Edmonds and Kennedy (2012) refer research design to the arrangement of provisions for collection and analysis of data using an approach that aims at merging relevance of the research purpose with economy in the procedure. Babbie (2007) view research design as a plan that helps the smooth sailing of a variety of research operations, thereby making research as competent as possible, hence yielding utmost information with least expenditure on effort, time as well as money.

This research study used a descriptive research design. This design refers to a set of methods and procedures that describe variables. It involves gathering data that describe events and then organizes, tabulates, depicts, and describes the data. The author noted that, research design deals with the decision regarding: What techniques were used to gather data? What kind of sampling strategies and tools were used? How time and cost constraints were dealt with? The function of research design therefore is to provide for the collection of relevant evidence with minimal expenditure of effort, time and money.

Descriptive studies portray the variables by answering who, what, and how questions (Babbie, 2007). According to Collins and O'Cathain (2010), descriptive design is a process of collecting data in order to test hypothesis or to answer the questions of the current status of the subject under study. Its advantage is that, it is used extensively to describe behavior, attitude, characteristic and values. Since this study was investigating the role of custodial services offered by banks in the settlements and management of pension funds, by focusing on commercial banks in Kenya, descriptive research design was therefore be the best design to use.
3.3 Population and Sampling Design

3.3.1 Target Population

Greene (2011) described population as the entire group of individuals or items under consideration in any field of inquiry and have a common attribute. The target population of this study was the staff working at the custodial departments in the 12 commercial banks in Kenya that manage and settle pension funds. The target population of this study was therefore 177 staffs.

Table 3.1: Target Population

<table>
<thead>
<tr>
<th>Bank</th>
<th>Target Population</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank of Africa Kenya Ltd.</td>
<td>11</td>
</tr>
<tr>
<td>CFC Stanbic Bank Limited</td>
<td>13</td>
</tr>
<tr>
<td>Chase Bank (Kenya) Limited</td>
<td>11</td>
</tr>
<tr>
<td>Equity Bank Limited</td>
<td>18</td>
</tr>
<tr>
<td>Kenya Commercial Bank Limited</td>
<td>14</td>
</tr>
<tr>
<td>National Bank of Kenya limited</td>
<td>18</td>
</tr>
<tr>
<td>NIC Bank Limited</td>
<td>14</td>
</tr>
<tr>
<td>Prime Bank Limited</td>
<td>19</td>
</tr>
<tr>
<td>Standard Chartered Bank Kenya Limited</td>
<td>16</td>
</tr>
<tr>
<td>The Co-operative Bank of Kenya Limited</td>
<td>21</td>
</tr>
<tr>
<td>Equatorial Commercial Bank</td>
<td>9</td>
</tr>
<tr>
<td>Trans National Bank Limited</td>
<td>13</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>177</strong></td>
</tr>
</tbody>
</table>

3.3.2 Sampling Design

The sampling plan describes the sampling unit, sampling frame, sampling procedures and the sample size for the study. The study used a stratified random sampling to select 30% of the target population. According to Collins and O'Cathain (2010), this is a method of sampling that involves the division of a population into smaller groups known as strata. In stratified random sampling, the strata are formed based on members shared attributes or
characteristics. A random sample from each stratum was taken in a number proportional to the stratum's size then compared to the population. These subsets of the strata are were then pooled to form a random sample. According to Glicken (2008) a sample size of between 10% and 30% is a good representation of the target population. The sample size of this study was therefore 53 respondents.

Table 3.2: Sample Size

<table>
<thead>
<tr>
<th>Bank</th>
<th>Target Population</th>
<th>Sampling Percent</th>
<th>Sample Size</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank of Africa Kenya Ltd.</td>
<td>11</td>
<td>30</td>
<td>3</td>
</tr>
<tr>
<td>CFC Stanbic Bank Limited</td>
<td>13</td>
<td>30</td>
<td>4</td>
</tr>
<tr>
<td>Chase Bank (Kenya) Limited</td>
<td>11</td>
<td>30</td>
<td>3</td>
</tr>
<tr>
<td>Equity Bank Limited</td>
<td>18</td>
<td>30</td>
<td>5</td>
</tr>
<tr>
<td>Kenya Commercial Bank Limited</td>
<td>14</td>
<td>30</td>
<td>4</td>
</tr>
<tr>
<td>National Bank of Kenya limited</td>
<td>18</td>
<td>30</td>
<td>5</td>
</tr>
<tr>
<td>NIC Bank Limited</td>
<td>14</td>
<td>30</td>
<td>4</td>
</tr>
<tr>
<td>Prime Bank Limited</td>
<td>19</td>
<td>30</td>
<td>6</td>
</tr>
<tr>
<td>Standard Chartered Bank Kenya Limited</td>
<td>16</td>
<td>30</td>
<td>5</td>
</tr>
<tr>
<td>The Co-operative Bank of Kenya Limited</td>
<td>21</td>
<td>30</td>
<td>6</td>
</tr>
<tr>
<td>Equatorial Commercial Bank</td>
<td>9</td>
<td>30</td>
<td>3</td>
</tr>
<tr>
<td>Trans National Bank Limited</td>
<td>13</td>
<td>30</td>
<td>4</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>177</strong></td>
<td><strong>30</strong></td>
<td><strong>53</strong></td>
</tr>
</tbody>
</table>

3.4 Data Collection Method

The study used primary data which was collected by use of self-administered questionnaires; the questionnaires included structured and unstructured questions. Denscombe (2007) observed that, a questionnaire defines the problem and the specific study objectives of a study. Questionnaires items may be closed ended or open ended type. As regards to the former, closed ended questions only allowed specific types of responses (such as Yes or No and likert scales) while with respect to the open ended type, the respondents state responses as they wish. Self-administered questionnaires were
preferred in this study because they are very economical in terms of time, energy and finances. The structured questions were used in an effort to conserve time and money as well as to facilitate an easier analysis as they are in immediate usable form; while the unstructured questions were used as they encourage the respondent to give an in-depth and felt response without feeling held back in revealing of any information.

3.5 Research Procedures

This refers to the means the study uses to gather the required data or information (Edmonds & Kennedy, 2012). The study used questionnaires to collect primary data. The questionnaire was administered by use of a drop off and pick up later method to the sampled respondents. According to Glicken (2008) the use of the Drop-off/Pick-Up (DOPU) method results in significantly high response rates. In addition, the DOPU technique is an effective means to reduce potential non-response bias through increased response rate.

3.5.1 Pilot Test

Pilot survey is a small scale replica and rehearsal of the main study. It assists in determining the suitability and ease of use of the research instruments and the operational aspects of administering the questionnaire. The purpose of a pilot test is to discover possible weaknesses, inadequacies, ambiguities and problems in any aspect of the research process (Edmonds & Kennedy, 2012).

Validity was ensured by having objective questions included in the questionnaire. This was achieved by pre-testing the instrument to be used to identify and change any ambiguous, awkward, or offensive questions and technique as emphasized by Glicken (2008). The validity of the research instruments was established by seeking opinions of experts in the field of study especially the supervisors.

Reliability on the other hand was ensured by pre-testing the questionnaire with a selected sample from the other departments other than marketing department. An internal consistency technique was applied by use of Cronbach’s Alpha. The alpha value ranges between 0 and 1 with reliability increasing with the increase in value. Coefficient of 0.6-0.7 is a commonly accepted rule of thumb that indicates acceptable reliability and 0.8 or higher indicated good reliability. The pilot data was not included in the actual study.
3.6 Data Collection Methods

Data analysis was done after data collection. The type of data analysis tool used was dependent on the type of data, that is; if the data was qualitative or quantitative? (Edmonds & Kennedy, 2012). Qualitative data was checked for completeness and cleaned ready for data analysis. Content analysis was used in processing of the data and results will be presented in a prose form. The study also used correlation analysis to establish the effectiveness of various custodial services improvement strategies.

The quantitative data in this research was analyzed by use descriptive statistics, using the Statistical Package for Social Sciences (SPSS ver. 20). Descriptive statistics such as mean, frequency, standard deviation and percentages were used to analyze data, which was then presented in tables and figures (bar charts and pie charts).

3.7 Chapter Summary

The chapter looks at the research methodology that was used in the study. The research design is described, the population under study and the target population. The researcher enumerates the sample size and discusses different sampling techniques. The most applicable sampling technique for the study at hand was selected. The data collection instruments for this study were questionnaires and the instruments were tested to ensure reliability and validity. The procedure for data collection was highlighted and subsequently the data was analyzed and presented. Chapter four presents the results and findings of the study.
CHAPTER FOUR

4.0 RESULTS AND FINDINGS

4.1 Introduction

This chapter presents data analysis and interpretation of the findings. The purpose of this study was to find out the role of custodial services offered by banks in the settlements and management of pension funds by focusing on commercial banks in Kenya. The study also sought to establish the financial assets under custody in commercial banks in Kenya, to determine the challenges facing custodial services offered by banks in the settlements and management of pension funds and to determine strategies that can be used to improve custodial services in commercial banks in Kenya.

The sample size of this study was 53 staffs working in the department of custodial services in commercial banks in Kenya that offer custodial services. Out of 53 individuals, 50 comprehensively filled and returned their questionnaires. This represents a 94.3% response rate.

![Pie chart showing response rate](image)

**Figure 4.1: Response rate**
4.2 General Information

In this section, the respondents were requested to indicate their age bracket, whether their banks were offering custodial services and for how long they had been working in the custodial department.

4.2.1 Age Bracket

The respondents were asked to indicate their age bracket. From the findings, 70% of the respondents indicated that they were aged between 25 and 35 years, 24% indicated that they were aged between 36 and 45 years, 4% indicated that they were aged between 46 and 55 years and 2% indicated that they were below 25 years in age. This shows that most of the respondents were aged between 25 and 25 years.

![Age Bracket Chart]

Figure 4.2: Age Bracket

4.2.2 Custodial Services in Banks

The respondents were further asked to indicate whether their banks were offering custodial services. According to the findings, all the respondents (100%) indicated that their banks were offering custodial services and hence they were fit to answers questions related to custodial services. The respondents also indicated that their clients included fund managers, individuals, global custodians, insurance, foreign investors, Tele posta, NSSF, KESREF, Old mutual, RBA, CMA, KPLC, Jua Kali sector, KRA, Churches like Kenya Methodist, Kenya Ports Authority and Schools.
4.2.3 Duration in the Custodial Department

The respondents were requested to indicate for how long they had been working in the custodial department. According to the findings, 36% of the respondents reported that they had been working in the custodial department for less than 2 years, 32% indicated for between 2 and 5 years, 28% indicated for between 6 and 9 years and 4% indicated for between 10 and 13 years.

![Duration in the Custodial Department](image)

**Figure 4.3: Duration in the Custodial Department**

4.3 Custodial Assets

The first objective of this study was to establish the financial assets under custody in commercial banks in Kenya.

4.3.1 Custodial Services offered by Banks

The respondents were asked to indicate whether their banks were offering the stated custodial services. According to the findings, all the respondents (100%) indicate that their banks were offering settlements services, proxy voting, inward and outward remittances, reporting, income collection and corporate actions like bonus issues and rights issues. In addition, 92% of the respondents indicated that their banks were offering safe keeping services. Further, 92% of the respondents indicated that their banks were offering valuation services. Additionally, 84% of the respondents reported that their banks were offering cash management and foreign exchange conversion. Further, 66% of
The respondents reported that their banks were offering registration services and 64% indicated that their banks were offering tax reclamation services. From these findings we can deduce that the most common custodial services in Kenya include settlements services, proxy voting, inward and outward remittances, reporting, income collection, corporate actions like bonus issues and rights issues, safe keeping services, valuation services, cash management and foreign exchange while registration and tax reclamation services are the most uncommon.

Table 4.1: Custodial Services offered by Banks

<table>
<thead>
<tr>
<th>Custodial services</th>
<th>Frequency</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Settlements</td>
<td>50</td>
<td>0</td>
</tr>
<tr>
<td>Safe keeping</td>
<td>48</td>
<td>2</td>
</tr>
<tr>
<td>Corporate actions e.g. bonus issues, rights issues</td>
<td>50</td>
<td>0</td>
</tr>
<tr>
<td>Registration</td>
<td>33</td>
<td>17</td>
</tr>
<tr>
<td>Proxy voting</td>
<td>50</td>
<td>0</td>
</tr>
<tr>
<td>Tax reclamation</td>
<td>32</td>
<td>18</td>
</tr>
<tr>
<td>Income collection</td>
<td>50</td>
<td>0</td>
</tr>
<tr>
<td>Valuation</td>
<td>46</td>
<td>4</td>
</tr>
<tr>
<td>Reporting</td>
<td>50</td>
<td>0</td>
</tr>
<tr>
<td>Inward and outward remittances</td>
<td>50</td>
<td>0</td>
</tr>
<tr>
<td>Foreign Exchange Conversion</td>
<td>42</td>
<td>8</td>
</tr>
<tr>
<td>Cash Management</td>
<td>42</td>
<td>8</td>
</tr>
</tbody>
</table>

The respondents were also asked to indicate whether their banks were offering custodial services for the stated assets. From the findings, all the respondents (100%) indicate that their banks were offering services for shares, provident funds and trust funds. Further, 96% of the respondents reported that their banks were offering custodial services for bonds, treasury bonds and pension funds. In addition, 92% indicated that their banks were offering insurance funds and 48% indicate that their banks were offering custodial services for commodities such as precious metals and currency (cash).
The respondents also indicated that their banks were offering custodial services for treasury bills, land/real estates, title deeds, corporate bonds, commercial papers, offshore investment, unit trusts, money market investments and Escrow funds.

### Table 4.2: Custodial Assets

<table>
<thead>
<tr>
<th>Custodial assets</th>
<th>Frequency</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Shares</td>
<td>50</td>
<td>0</td>
</tr>
<tr>
<td>Bonds</td>
<td>48</td>
<td>2</td>
</tr>
<tr>
<td>Treasury bonds</td>
<td>48</td>
<td>2</td>
</tr>
<tr>
<td>Commodities such as precious metals and currency (cash)</td>
<td>24</td>
<td>26</td>
</tr>
<tr>
<td>Pension Funds</td>
<td>48</td>
<td>2</td>
</tr>
<tr>
<td>Provident Funds</td>
<td>50</td>
<td>0</td>
</tr>
<tr>
<td>Insurance Funds</td>
<td>46</td>
<td>4</td>
</tr>
<tr>
<td>Trust Funds</td>
<td>50</td>
<td>0</td>
</tr>
</tbody>
</table>

#### 4.4 Challenges Facing Custodial Services offered by Banks

The second objective of this study was to determine the challenges facing custodial services offered by banks in the settlements and management of pension funds.

##### 4.4.1 Adoption of Technology and Custodial Services

The respondents were asked to rate the adoption of technology that helps in custodial services in their bank as compared to other banks. According to the findings, 64% of the respondents rated the adoption of technology that helps in custodial services in their bank as good, 28% rated it as excellent while 8% rated it as moderate. From these findings we can deduce that most commercial banks had adopted technology that helps in custodial services.
4.4.2 Increasing complexity and diversity of assets

The respondents were asked to indicate the extent to which increasing complexity and diversity of assets affect custodial services. According to the findings, they indicated with a mean of 3.02 and a standard deviation of 0.9151 that increasing complexity and diversity of assets was affecting custodial services to a great extent.

4.4.3 Increased Technology

The respondents were also requested to indicate the extent to which technology was affecting custodial services. From the findings, the respondents indicated with a mean of 3.0200 and a standard deviation of 1.09712 that increased technology was affecting custodial services to a moderate extent.

4.4.4 Competition from CSDs in banking services

The researcher requested the respondents to indicate the extent to which competition from CSDs in banking services was affecting custodial services. From the findings, the respondents indicated with a mean of 2.8200 and a standard deviation of 1.00387 that competition from CSDs in banking services was affecting custodial services to a moderate extent.
4.4.5 Competition in cross border access

The researcher also asked the respondents to indicate the extent to which competition in cross border access was affecting custodial services. According to the findings, the respondents indicated with a mean of 2.9800 and a standard deviation of 1.05926 that competition in cross border access was affecting custodial services to a moderate extent.

4.4.6 Risks incurred by custodians

The respondents were requested to indicate the extent to which risks incurred by custodians were affecting custodial services. The findings indicated that the respondents indicated with a mean of 2.7200 and a standard deviation of 1.03095 that risks incurred by custodians were affecting custodial services to a moderate extent.

4.4.7 Risks incurred by custody clients

The researcher also requested the respondents to indicate the extent to which risks incurred by custody clients were affecting custodial services. According to the findings, the respondents indicated with a mean of 2.6400 and a standard deviation of 0.96384 that risks incurred by custody clients were affecting custodial services to a moderate extent.

4.4.8 Globalization of Financial Markets

The respondents were also requested to indicate the extent to which globalization of financial markets was affecting custodial services. From the findings, the respondents indicated with a mean of 3.1800 and a standard deviation of 1.10083 that globalization of financial markets was affecting custodial services to a moderate extent.
Table 4.3: Challenges in offering Custodial Services

<table>
<thead>
<tr>
<th>Challenge</th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increasing complexity and diversity of assets</td>
<td>3.0200</td>
<td>0.91451</td>
</tr>
<tr>
<td>Increased Technology</td>
<td>3.0200</td>
<td>1.09712</td>
</tr>
<tr>
<td>Competition from CSDs in banking services</td>
<td>2.8200</td>
<td>1.00387</td>
</tr>
<tr>
<td>Competition in cross border access</td>
<td>2.9800</td>
<td>1.05926</td>
</tr>
<tr>
<td>Risks incurred by custodians</td>
<td>2.7200</td>
<td>1.03095</td>
</tr>
<tr>
<td>Risks incurred by custody clients</td>
<td>2.6400</td>
<td>0.96384</td>
</tr>
<tr>
<td>Globalization of Financial Markets</td>
<td>3.1800</td>
<td>1.10083</td>
</tr>
</tbody>
</table>

4.4.9 Transaction risk

The researcher requested the respondents to indicate the extent to which banks were facing transaction risk. From the findings, the respondents indicated with a mean of 2.9800 and a standard deviation of 1.15157 that their banks were facing transaction risk to a moderate extent.

4.4.10 Compliance risk

The respondents were requested to indicate the extent to which their banks were facing compliance risk. According to the findings, the respondents indicated with a mean of 2.6000 and a standard deviation of 1.08797 that their banks were facing compliance risk to a moderate extent.

4.4.11 Credit risks

The researcher further requested the respondents to indicate the extent to which their banks were facing credit risks. According to the findings, the respondents indicated with a mean of 2.6600 and a standard deviation of 1.06157 that their banks were facing credit risks to a moderate extent.
4.4.12 Strategic risk

The respondents were further requested to indicate the extent to which their banks were facing strategic risk. From the findings, the respondents indicated with a mean of 2.6000 and a standard deviation of 1.08797 that their banks were facing strategic risk to a moderate extent.

4.4.13 Reputation risk

Lastly, the researcher requested the respondents to indicate the extent to which their banks were facing reputation risk. According to the findings, the respondents indicated with a mean of 2.5400 and a standard deviation of 1.23239 that their banks were facing reputation risk to a moderate extent.

Table 4.4: Risks in offering Custodial Services

<table>
<thead>
<tr>
<th>Risk Type</th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transaction risk</td>
<td>2.9800</td>
<td>1.15157</td>
</tr>
<tr>
<td>Compliance risk</td>
<td>2.6000</td>
<td>1.08797</td>
</tr>
<tr>
<td>Credit risks</td>
<td>2.6600</td>
<td>1.06157</td>
</tr>
<tr>
<td>Strategic risk</td>
<td>2.6000</td>
<td>1.08797</td>
</tr>
<tr>
<td>Reputation risk</td>
<td>2.5400</td>
<td>1.23239</td>
</tr>
</tbody>
</table>

4.5 Strategies that can be used to improve Custodial Services

The third objective of this study was to determine strategies that can be used to improve custodial services in commercial banks in Kenya. The respondents were also asked to indicate how their banks dealt with the above risks. From the findings the respondents indicated that to deal with transaction risk their banks used market checker process, to deal with reputation risk their banks used excellent services and to deal with compliance their banks used audits (internal and external). The respondents also indicated that their banks used frequent audits and constant operational risks review, regular staff training and updates and standardization of process. In addition, the banks were the banks were doing follow-ups on queries and solving them in due time. Further, the respondents indicated that their banks were complying with all the regulatory requirements and advocating for high level of integrity.
4.5.1 Strategies to improve Custodial Services offered in Banks

4.5.1.1 Improvement of governance

The respondents were further requested to indicate the extent to which they agreed with the strategies provided. From the findings, the respondents agreed with a mean of 4.3000 and a standard deviation of 0.97416 that improvement of governance can improve custodial services offered in banks.

Regulation by CBK

The researcher requested the respondents to further indicate the extent to which they agreed with the strategies provided. According to the findings, the respondents further agreed with a mean of 4.1400 and a standard deviation of 0.88086 that regulation by CBK can improve custodial services offered in banks.

Reduction of various risks

The respondents were also requested to indicate the extent to which they agreed with the strategies provided. From the findings, the respondents strongly agreed with a mean of 4.7200 and a standard deviation of 0.45356 that reduction of various risks can improve custodial services offered in banks.

Improve Staffing

The researcher also requested the respondents to indicate the extent to which they agreed with the strategies provided. From the findings, the respondents strongly agreed with a mean of 4.5200 and a standard deviation of 0.81416 that improving staffing can improve custodial services offered in banks.

Ensure Trade Compliance

The respondents were also requested to indicate the extent to which they agreed with the strategies provided. According to the findings, the respondents strongly agreed with a mean of 4.6400 and a standard deviation of 0.48487 that ensuring trade compliance can improve custodial services offered in banks.
Table 4.5: Strategies to improve Custodial Services offered in Banks

<table>
<thead>
<tr>
<th></th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Improvement of governance</td>
<td>4.300</td>
<td>.97416</td>
</tr>
<tr>
<td>Regulation by CBK</td>
<td>4.140</td>
<td>.88086</td>
</tr>
<tr>
<td>Reduction of various risks</td>
<td>4.720</td>
<td>.45356</td>
</tr>
<tr>
<td>Improve Staffing</td>
<td>4.520</td>
<td>.81416</td>
</tr>
<tr>
<td>Ensure Trade Compliance</td>
<td>4.640</td>
<td>.48487</td>
</tr>
</tbody>
</table>

4.6 Correlation Analysis

A correlation is a number between -1 and +1 that measures the degree of association between the strategies for improving custodial services and custodial services improvement. A positive value for the correlation implies a positive. A negative value for the correlation implies a negative or inverse association.

From the correlation analysis, the study found that there is a positive relationship between improvement of governance and improvement of custodial services, where the correlation coefficients were 0.102 and a p-value of 0.000. The study also found that regulation by CBK and improvement of custodial services correlate positively with correlation coefficients of 0.398 and p-value of 0.000. The study further established that there is a positive relationship between reduction of various risks and improvement of custodial services with a correlation coefficient of 0.76 and p-value of 0.001. The study further revealed that there is a positive relationship between improving staffing and improvement of custodial services with a correlation coefficient of 0.209 and p-value of 0.020. Lastly, the study found that there is a positive relationship between ensuring trade compliance and improvement of custodial services with a correlation coefficient of 0.0.007 and a p-value of 0.03. This infers that reductions in various risks was the most effective strategy in improving custodial services followed by regulation by CBK, improving staffing, improvement of governance and ensuring trade compliance.
Table 4.6: Correlation Coefficients

<table>
<thead>
<tr>
<th></th>
<th>Improvement of custodial services</th>
<th>Improvement of governance</th>
<th>Regulation by CBK</th>
<th>Reduction of various risks</th>
<th>Improve Staffing</th>
<th>Ensure Trade Compliance</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Improvement of custodial services</strong></td>
<td>Pearson Correlation</td>
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<td>.102</td>
<td>-.098</td>
<td>.076</td>
<td>-.209</td>
</tr>
<tr>
<td></td>
<td>Sig. (2-tailed)</td>
<td></td>
<td>.480</td>
<td>.499</td>
<td>.602</td>
<td>.145</td>
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<td></td>
<td>N</td>
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<td>50</td>
<td>50</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td><strong>Improve Staffing</strong></td>
<td>Pearson Correlation</td>
<td>.102**</td>
<td>1</td>
<td>.782**</td>
<td>.443**</td>
<td>.579**</td>
</tr>
<tr>
<td></td>
<td>Sig. (2-tailed)</td>
<td>.000</td>
<td>.000</td>
<td>.000</td>
<td>.001</td>
<td>.000</td>
</tr>
<tr>
<td></td>
<td>N</td>
<td>.000</td>
<td>.000</td>
<td>.000</td>
<td>.000</td>
<td>.000</td>
</tr>
<tr>
<td><strong>Ensure Trade Compliance</strong></td>
<td>Pearson Correlation</td>
<td>.398**</td>
<td>.782**</td>
<td>1</td>
<td>.304**</td>
<td>.380**</td>
</tr>
<tr>
<td></td>
<td>Sig. (2-tailed)</td>
<td>.000</td>
<td>.000</td>
<td>.000</td>
<td>.006</td>
<td>.503**</td>
</tr>
<tr>
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<td>.000</td>
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<td>.000</td>
</tr>
<tr>
<td><strong>Reduction of various risks</strong></td>
<td>Pearson Correlation</td>
<td>.398**</td>
<td>.782**</td>
<td>1</td>
<td>.304**</td>
<td>.380**</td>
</tr>
<tr>
<td></td>
<td>Sig. (2-tailed)</td>
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<td>.001</td>
<td>.001</td>
<td>.006</td>
<td>.503**</td>
</tr>
<tr>
<td></td>
<td>N</td>
<td>.001</td>
<td>.001</td>
<td>.001</td>
<td>.000</td>
<td>.000</td>
</tr>
<tr>
<td><strong>Regulation by CBK</strong></td>
<td>Pearson Correlation</td>
<td>.209*</td>
<td>.443**</td>
<td>.380**</td>
<td>-.261</td>
<td>.646**</td>
</tr>
<tr>
<td></td>
<td>Sig. (2-tailed)</td>
<td>.020</td>
<td>.001</td>
<td>.006</td>
<td>.067</td>
<td>.051</td>
</tr>
<tr>
<td></td>
<td>N</td>
<td>.020</td>
<td>.001</td>
<td>.006</td>
<td>.067</td>
<td>.051</td>
</tr>
<tr>
<td><strong>Improve Staffing</strong></td>
<td>Pearson Correlation</td>
<td>.007*</td>
<td>.579**</td>
<td>.503**</td>
<td>-.261</td>
<td>.277</td>
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<tr>
<td></td>
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<td>.000</td>
<td>.000</td>
<td>.000</td>
<td>.051</td>
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<tr>
<td></td>
<td>N</td>
<td>.030</td>
<td>.000</td>
<td>.000</td>
<td>.000</td>
<td>.051</td>
</tr>
</tbody>
</table>

**. Correlation is significant at the 0.01 level (2-tailed).
* . Correlation is significant at the 0.05 level (2-tailed).
4.7 Chapter Summary

This chapter presented the data analysis and interpretation of the findings. The chapter began with an introduction, followed by general information. This was then followed by results presentation for every objective. Chapter 5 presents discussion of the findings, conclusions, and recommendations for practice and further research on the problem.
CHAPTER FIVE

5.0 DISCUSSION, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This chapter presents discussion of the findings, conclusions and recommendations for practice and further research on the problem. The chapter begins with a summary of the study, followed by a discussion, conclusions and recommendations for practice improvement and for further studies.

5.2 Summary of the Study

The purpose of this study was to establish the role of custodial services offered by banks in the settlements and management of pension funds by focusing on commercial banks in Kenya. The study also sought to establish the financial assets under custody in commercial banks in Kenya; to determine the challenges facing custodial services offered by banks in the settlements and management of pension funds; and to determine strategies that can be used to improve custodial services in commercial banks in Kenya.

This research study used a descriptive research design. The target population of this study was the staff working at the custodial departments in the 12 commercial banks in Kenya that manage and settle pension funds. The target population of this study was therefore 177 staffs. The study used a stratified random sampling to select 30% of the target population. The sample size of this study was therefore 53 respondents. The questionnaires were administered by use of a drop off and pick up later method to the sampled respondents. Qualitative data was checked for completeness and cleaned ready for data analysis. Content analysis was used in processing of the data and results were presented in a prose form. Descriptive statistics such as mean, frequency, standard deviation and percentages were used to analyze data, which was then presented in tables and figures (bar charts and pie charts).

The first objective of this study was to establish the financial assets under custody in commercial banks in Kenya. The study established that the most common custodial services in Kenya include settlements services, proxy voting, inward and outward remittances, reporting, income collection, corporate actions like bonus issues and rights
issues, safe keeping services, valuation services, cash management and foreign exchange while registration and tax reclamation services are the most uncommon. The study further found out that respondents’ banks were offering custodial services for treasury bills, land/real estates, title deeds, corporate bonds, commercial papers, offshore investment, unit trusts, money market investments and Escrow funds.

The second objective of this study was to determine the challenges facing custodial services offered by banks in the settlements and management of pension funds. The study established that most commercial banks had adopted technology that helps in custodial services. Further, the study also established that that increasing complexity and diversity of assets was affecting custodial services to a great extent. In addition, the study established that increased technology and competition from CSDs in banking services were affecting custodial services to a moderate extent.

Additionally, the study found out that competition in cross border access, risks incurred by custodians, risks incurred by custody clients and globalization of financial markets was affecting custodial services to a moderate extent. It was also revealed that the respondents’ banks were facing compliance risk, credit risks, strategic risk and reputation risk to a moderate extent.

The third objective of this study was to determine strategies that can be used to improve custodial services in commercial banks in Kenya. The study established that to deal with transaction risk their banks used market checker process, to deal with reputation risk their banks used excellent services and to deal with compliance their banks used audits (internal and external). In addition the study revealed that the respondents’ banks used frequent audits and constant operational risks review, regular staff training and updates and standardization of process. In addition, the banks were doing follow-ups on queries and solving them in due time. Again, the study established that the respondents’ banks were complying with all the regulatory requirements and advocating for high level of integrity.

The study also found out that improvement of governance, ensuring trade compliance, reduction of various risks, improving staffing and regulation by CBK can improve custodial services offered in banks.
5.3 Discussion of the Findings

5.3.1 Custodial Assets

This study established that all the 12 commercial banks in Kenya that offer custodial services were offering settlements services, proxy voting, inward and outward remittances, reporting, income collection and corporate actions like bonus issues and rights issues. This finding concurs with Mongelli, Dorrucci, and Agur (2005) argument concerning the services offered in custody industry. The security services offered include including safekeeping and settlement, reporting, corporate actions, dividends collection and distribution, proxy voting, tax reclaim services, fund administration and making available market news and information. Nonetheless, not all banks are offering these services with even fewer offering registration services and tax reclamation services, valuation services, cash management and foreign exchange conversion.

In relation to custodial assets the study established that commercial banks in Kenya were offering services for shares, provident funds and trust funds, bonds, treasury bonds, pension funds, insurance funds and commodities such as precious metals and currency (cash). These findings agree with the arguments postulated by Lapavitsas et al. (2010) that in various types of custodian assets worldwide shares are one of them. Additionally, earlier studies by Bigger and Bigger (2010) had attempted to group bonds with shares as custody assets when they were offered by credit institutions, public establishments and companies as well as supranational organizations. Further, some banks were also offering custodial services for land/real estates, treasury bills, title deeds, commercial papers, corporate bonds, unit trusts, offshore investment, money market investments and Escrow funds.

Treasury bonds are as well thought-out as custody assets. A treasury bond is a bond issued by a state government, commonly with an assurance to pay periodic interest payments plus to repay the face value on the maturity date. Treasury bonds are frequently denominated in the country's own currency. Treasury bonds are issued by national governments in foreign currencies are usually referred to as sovereign bonds, even though the word sovereign bond may as well refer to bonds issued in a country's own currency (Burton, 2013). Custodian assets also include a host of other items. These items include precious metal. A precious metal is a naturally occurring chemical element that is metallic
of high economic worth. Another form of custodian asset is pension funds which in many countries are administered by banks. Giarraputo (2005), argues that a pension fund is a scheme, plan or fund that offers retirement income.

Another form of custodian asset is the insurance. This is termed as the equitable transfer of threat of a loss, from one particular entity to another in payments. It can also be said to be a form of risk hedge in risk management techniques. It can also be tied to the financial services whereby accounts checking, asset valuation and information disclosure are part of the bigger role it plays.

5.3.2 Challenges facing Custodial Services offered by Banks

The study established that most commercial banks that were offering custodial services had adopted technology that helps in custodial services. This finding agrees with some arguments in recent literature with regard to global custodians. Global custodians need investing not only in processing, technology and report on these new asset types, but also require the implementation of additional risk controls in operations. The study also established that globalization of financial markets and the increasing complexity and diversity of assets were affecting custodial services in commercial banks in Kenya. This is in line with the arguments of Lim (2013). The among the main the forces that are most probable to determine the custody industry in future comprise of factors such as increased demand for global liquidity management solutions, continued globalization of the financial markets and leading to changes in the investment patterns of institutional investors.

The study also revealed that increased technology, competition in cross border access and competition from CSDs in banking services were affecting custodial services. This agrees with arguments made by Riley (2006) that CSDs with banking permits compete in services that involve credit risk taking with custodian banks. These services are securities financing, liquidity provision for settlement and collateral management.

It was also revealed that risks incurred by custodians as well as risks incurred by custody clients were affecting custodial services. This also concurs with ideas of Riley (2006) that risks may arise in the situation of their provision of custody services for the custodians when they are related to particular consequences and specific activities.
The study also established that commercial banks in Kenya were facing liquidity risk, settlement risk-delayed funding, duplicate risks and fraud risk. In addition, commercial banks in Kenya had a challenge with late clients' instructions, challenges relating to inefficient players like other banks and carpeting with upcoming custodians with flexible policies. In addition there is limited knowledge on the products and services, lack of market specific technologies and lack of skills within the market.

In relation to risks of offering custodial services, the study established that the most common types of risks include transaction risk, compliance risk, credit risks, strategic risk and reputation risk. A credit risk according to Dierick et al. (2005) is the risk that a client is not able to meet full obligations for to the custodian maybe due to insolvency.

In dealing with transaction risk the study found that banks were using market checker process. On the other hand banks were offering excellent services to deal with reputation risk and were using audits (internal and external) to deal with compliance risk. Further, the study found that banks were using. The frequent audits and constant operational risks review, regular staff training and updates and standardization of process to deal with risks. In addition, the banks were doing follow-ups on queries and solving them. Further, the study found that banks were complying with all the regulatory requirements and advocating for high level of integrity as way of dealing with risks in offering custodial service.

5.3.3 Strategies that can be used to improve Custodial Services

In relation to strategies that can be used to improve custodial services offered in banks, the study found that several strategies can be used. One of the strategies established was reduction of various risks. This concurs with arguments by Fishwick and Bernard (2012) that the improvement of custodial services can be done through reduction of operational, legal and financial. Other strategies include improving staffing and improvement of governance. More to this, Rudroff (2009) established that in the current environment immovability and character are also essential. Individuals and families that have a high net worth seek for custodians that have a strong brand name in the world of investment banking and have a constructive global reputation.
However these strategies are regulated by the CBK since all custodian services are regulated by the CBK. The custodian services can only be practiced when a license is issued. This regulation is intended to ensure that transparency, professionalism and accountability are maintained at all time.

These strategies and services face some risks by the custodians. These risks are also faced by the clients to these services. These parties to these risks can be categorized into three main categories namely: legal, operational and financial categories. The conditions in which these risk crops up differ. Globally, there is a universal risk that can be caused by financial or operational failure of a custodian that is a large institution that is financial. However, such risks are not for the provision of custody services specifically.

The study also established that ensuring trade compliance can improve custodial services offered in banks. All applicable regulations and laws relevant to the custody business should be communicated to the relevant personnel. The custodian should establish a system to ensure compliance with applicable regulations and laws.

Chan et al., (2007) one of the most common issues that face compliance is the compliance with the local law. Additionally, substantiation and recordkeeping requirements, mutual fund custody and fiduciary actions are also faced with regard to compliance. Specifically, reporting services and recordkeeping should ensure that they meet all the needs of customer so that with the existing as there are easily vetted.

The study also identified that reduction of various risks can improve custodial services offered in banks. One of the risks faced include operational risks. This risk can be mitigated through a system of strict and suitable controls. It is the role of custodians to identify the risk involved, device mean of controlling it and establish follow up procedures that will ensure that the controls instituted are competent and sufficient.

In addition, legal risks cannot be sufficiently controlled by the custodian. This is because these risks rely on certainty within the legal regime that is applicable and also the consistency between the rights of the custodian and the obligations on clients and CSDs.

There are extensive regulatory controls established to regulate bank custodians, and in many markets precise requirements are enforced on the arrangements of custody of
institutional investors such as joint investment plans, which tend to inflict submission
necessities on their custodian banks.

5.4 Conclusion

5.4.1 Custodial Assets

This study concludes that custodial services in the 12 commercial banks in Kenya include
shares, provident funds and trust funds, bonds, treasury bonds, pension funds, insurance
funds and commodities such as precious metals and currency (cash). In addition, some
banks offer custodial services for treasury bills, land/real estates, title deeds, corporate
bonds, commercial papers, offshore investment, unit trusts, money market investments
and Escrow funds.

5.4.2 Challenges facing Custodial Services offered by Banks

In relation to challenges facing custodial services offered by banks, the study concludes
that globalization of financial markets, increasing complexity and diversity, increasing
technology, competition in cross border access and competition from CSDs and risks
incurred by both custodians and custody clients. Other challenges include late clients’
instructions, challenges relating to inefficient players like other banks lack of market
specific technologies and lack of skills within the market.

The study also concludes that banks use frequent audits and constant operational risks
review, regular staff training and updates and standardization of process to deal with risks
and challenges. In addition, commercial banks do follow-ups on queries and solving them
in due time.

5.4.3 Strategies that can be used to improve Custodial Services

In relation to strategies that can be used to improve custodial services offered in banks,
the study established that banks can ensure trade compliance, improve staffing and
improve governance and regulation by CBK. In addition, sensitization of the custody
certification to boost its value can improve custodial services offered in banks. Other
strategies that bank use include constant stakeholder’s involvement, regular update to
meet the market requirements, establishment of a body that advocates for the rights of
custodians, and investment in technology.
5.5 Recommendations

5.5.1 Suggestions for Improvement

5.5.1.1 Financial Assets under Custody

This study established that some banks were not offering custodial services offered by other banks. For instance, some banks were not offering registration and tax reclamation services. This study therefore recommends that commercial banks in Kenya should increase their range of custodial services so as to have more clients.

5.5.1.2 Challenges facing Custodial Services offered by Banks

This study established that globalization of financial markets and increasing complexity and diversity are some of the challenges that commercial banks are facing. This study therefore recommends that commercial banks in Kenya should improve their technology so as to deal with increasing complexity and diversity in the industry.

To deal with competition in cross border access and competition from CSDs, the study recommends that commercial banks in Kenya should come up with better marketing strategies and promotions so as to attract more customers.

To deal with various types of risks, commercial banks should ensure frequent audits, constant operational risks review, regular staff training and updates and standardization of process. In addition, commercial banks do follow-ups on queries and solving them in due time.

5.5.1.3 Strategies that can be used to improve Custodial Services

In relation to strategies to improve custodial services, this study recommends that commercial banks in Kenya should ensure trade compliance, regular stakeholder’s involvement, improve staffing and improve governance.

In addition, the study recommends that the Central bank of Kenya and the government of Kenya should formulate more policies to govern the custody industry. This may involve policies that regulate market entry and policies that protect custodians and custody clients.
5.5.2 Suggestion for Further Research

This study was limited to role of custodial services offered by banks in the settlements and management of pension funds. The study therefore recommends further studies in the area of factors affecting the custody industry in Kenya. This should include other non-bank institutions that offer custodial services.
REFERENCES


APPENDICES

Appendix I: Questionnaire

1. Age Bracket
   - Below 25 years [ ]
   - 25 to 35 years [ ]
   - 36 to 45 years [ ]
   - 46 to 55 years [ ]
   - More than 55 years [ ]

2. Does your bank offer custodial services?
   - Yes [ ]
   - No [ ]

3. If yes, who are your clients?
   i. ........................................................................................................
   ......
   ii. ........................................................................................................
   ......
   iii. ........................................................................................................
   ......
   iv. ........................................................................................................
   ......

4. For how long have you been working in the custodial department?
   - Less than 2 years [ ]
   - 2 to 5 years [ ]
   - 6 to 9 years [ ]
   - 10 to 13 years [ ]
   - More than 13 years [ ]
**Custodial Assets**

5. Does your bank offer the following custodial services?

<table>
<thead>
<tr>
<th>Custodial services</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>Settlements</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Safe keeping</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Corporate actions e.g. bonus issues, rights issues</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Registration</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Proxy voting</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax reclamation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income collection</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Valuation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reporting</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inward and outward remittances</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign Exchange Conversion</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash Management</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

6. Does your bank offer custodial services for the following assets?

<table>
<thead>
<tr>
<th>Custodial assets</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shares</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bonds</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Treasury bonds</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commodities such as precious metals and currency (cash)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pension Funds</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Provident Funds</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Insurance Funds</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Trust Funds</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
7. Apart from the ones named above, which other assets does your bank offer custodial services for?
   i. ...........................................................................................................
   
   ii. ............................................................................................................
   
   iii. ............................................................................................................
   
   iv. .............................................................................................................

Challenges facing custodial services offered by banks

8. How do you rate the adoption of technology that helps in custodial services in your bank as compared to other banks?

   Excellent [ ] Good [ ]
   Moderate [ ] Bad [ ]
   Poor [ ]

9. To what extent has your bank been experiencing the following challenges in offering custodial services? Where 5=very great extent, 4=great extent, 3=moderate extent, 2=low extent and 1=no extent at all.

<table>
<thead>
<tr>
<th>Challenges</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increasing complexity and diversity of assets</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Increased Technology</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Competition from CSDs in banking services</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Competition in cross border access</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Risks incurred by custodians</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Risks incurred by custody clients</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Globalization of Financial Markets</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

10. Which other challenges does your bank face in offering custodial services?
   i. .............................................................................................................
   ii. ............................................................................................................
   iii. .........................................................................................................
11. To what extent does your bank face the following risks in offering custodial services? Where 5=very great extent, 4=great extent, 3=moderate extent, 2=low extent and 1=no extent at all.

<table>
<thead>
<tr>
<th>Risks</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transaction risk</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Compliance risk</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Credit risks</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Strategic risk</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reputation risk</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

12. How does your bank deal with the above risks?

……………………………………………………………………………………
……………………………………………………………………………………
……………………………………………………………………………………

**Strategies that can be used to improve custodial services**

13. To what extent do you agree that the following strategies can improve custodial services offered in banks? Where 5=strongly agree, 4=agree, 3=neutral, 2=disagree and 1=strongly disagree.

<table>
<thead>
<tr>
<th>Strategies</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Improvement of governance</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Regulation by CBK</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reduction of various risks</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Improve Staffing</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ensure Trade Compliance</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

14. Apart from the ones named above, which other strategies can be used to improve custodial services offered in banks?

i. ..............................................................

ii. ..............................................................

iii. ..............................................................

iv. ..............................................................
## Appendix II: Registered Custodians - 2014

<table>
<thead>
<tr>
<th>Bank</th>
<th>Phone no</th>
<th>Permanent address</th>
<th>Physical Location</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank of Africa Kenya Ltd.</td>
<td>3275000</td>
<td>69562-00400, NAIROBI</td>
<td>Reinsurance Plaza, Taifa Road</td>
</tr>
<tr>
<td>CFC Stanbic Bank Limited</td>
<td>3638000</td>
<td>72833-00200, NAIROBI</td>
<td>CFC Stanbic Centre, Chiromo Road, Westlands</td>
</tr>
<tr>
<td>Chase Bank (Kenya) Limited</td>
<td>2774000</td>
<td>66049-00800, NAIROBI</td>
<td>Chase Bank, Riverside Drive, Chiromo Road</td>
</tr>
<tr>
<td>Equity Bank Limited</td>
<td>2262000</td>
<td>75104-00200, NAIROBI</td>
<td>Equity Bank Centre, Upper Hill</td>
</tr>
<tr>
<td>Kenya Commercial Bank Limited</td>
<td>2852000</td>
<td>30664-00100, NAIROBI</td>
<td>3rd Floor, Piedmont Plaza, Ngong Road</td>
</tr>
<tr>
<td>National Bank of Kenya limited</td>
<td>2828000</td>
<td>72866-00200, NAIROBI</td>
<td>National Bank Building, Harambee Avenue</td>
</tr>
<tr>
<td>NIC Bank Limited</td>
<td>2888000</td>
<td>44599-00100, NAIROBI</td>
<td>NIC House, Masaba Road, off Uhuru Highway</td>
</tr>
<tr>
<td>Prime Bank Limited</td>
<td>4203000</td>
<td>43825-00100, NAIROBI</td>
<td>Prime Bank, Riverside Drive, Chiromo</td>
</tr>
<tr>
<td>Standard Chartered Bank Kenya Limited</td>
<td>311893</td>
<td>30003-00100, NAIROBI</td>
<td>Standard Chartered Bank Head Office, Chiromo, Westlands</td>
</tr>
<tr>
<td>The Co-operative Bank of Kenya Limited</td>
<td>3276149</td>
<td>48231-00100, NAIROBI</td>
<td>Co-operative Bank House, Haile Selassie Avenue</td>
</tr>
<tr>
<td>Equatorial Commercial Bank</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Trans National Bank Limited</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>