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**An Analysis of the Role of Financial Custodians in Promoting Portfolio
Investment in Zimbabwe**

By

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DEDICATION

I would like to dedicate this dissertation for my wife Ivy for all the support and inspiration she gave during the preparation of this report.

DECLARATION

I, Muchapaziva Begede, do hereby declare that this dissertation is the result of my own investigation and research, except to the extent indicated in the Acknowledgements, References and by comments included in the body of the report, and that it has not been submitted in part or in full for any other degree to any other university.

Student signature

31/07/2015

Date

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Abstract

This study was motivated by the need to explore the role of financial custodians in attracting foreign portfolio investment to Zimbabwe. This study comes on the backdrop of a series of economic policies that have been adopted to attract foreign direct investment but with very limited success. This study seeks to explore the role of financial custodians in attracting investment into Zimbabwe through foreign portfolio investment as opposed to focusing on foreign direct investment, an approach which has failed to yield the desired results.

The aim of the research is to assess how an effective custodian services delivery system, its risk mitigation role in securities' trading and role in global integration can contribute to the mobilisation of foreign portfolio investment in an economy. This study used a cross sectional qualitative approach to gain in-depth knowledge through in-depth key informant interviews with 15 key informants selected from the “four wheels” of portfolio investment namely custodians, asset management firms, and stockbroking firms and settlements banks. Interviewer administered semi-structured and predominantly open ended questions were used for data collection.

The interviews were audio recorded and transcribed verbatim before being analysed using a qualitative data analysis method called template analysis which uses *a priori* themes obtained from literature review as the initial phase for a series of data coding and thematic analysis. It involves an iterative process which results in the identification of themes and sub-themes relating to the role of financial custodians. Iterative data analysis is conducted to come up with additional sub-themes which helps build cause-effect relationships between themes and sub-themes thereby resulting in a progressive accumulation of new insights. This approach is suitable in concept building in creating an environment where the benefits of financial custodians can be harnessed effectively to attract foreign portfolio investment.

The results indicated that by focusing on improving custodial service attractiveness, enhancing risk mitigation mechanisms, creating linkages with global custodians and eradicating information asymmetry in the market it is possible to attract foreign portfolio investment. The study therefore concludes to uphold the proposition that custodian role can be harnessed to promote foreign portfolio investment in Zimbabwe. It is recommended therefore that priority be given to the pooling of resources to build information technology infrastructures to link Zimbabwe with the global market as well as linking regional blocks while also expanding custodial service offerings to take advantage of emerging opportunities.

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ABBREVIATIONS

1. SECZ : The Securities and Exchange Commission of Zimbabwe
2. ZSE : The Zimbabwe Stock Exchange
3. FDI : Foreign Direct Investment
4. SWIFT : Society for the Worldwide Interbank Financial Telecommunication

CHAPTER 1

INTRODUCTION

1. Introduction

Empirical research has shown that Africa has the lowest propensity to save, with a sizeable number living on \$1 per day (Mpofu 2011). Given this situation, greater hope is in its ability to attract inflows from foreign investors. Yartey and Adjasi (2007), indicated that most African countries need to seriously consider the opportunities that lie in private capital flows, namely; portfolio investment; remittances and foreign direct investment. In 2003 portfolio investment constituted a meagre 0.15% of the total capital flow in Africa, excluding South Africa. On the contrary, the Johannesburg Stock Exchange has portfolio investments as the greatest contributor to their liquidity (Yartey & Adjasi 2007). This paper seeks to investigate how Zimbabwe can benefit from linkages that exist between portfolio investment inflows and operations of the custodial services sectors as part of a solution to its long standing liquidity challenges.

The growth potential which African countries continue to exhibit has seen African stock markets yielding higher returns in terms of price / earnings ratios and dividend returns compared to returns in developed countries (Nhavira, Mudzonga & Mugocha 2014). The level of securities trade in most African countries, however, is still far below the threshold that would attract meaningful portfolio investment which the World Bank estimated to be US\$50 billion in market capitalisation per annum and at least US\$10 billion per annum in values traded in 2006 (Nhavira, Mudzonga & Mugocha 2014). Given the above mention situation, this paper seeks to create a bridge through making recommendations as to how Zimbabwe can improve its efficiency in securities trading in a manner that minimises risks.

There is no justification to reinvent the wheel when there are known countries and regional blocks that already have “the winning formulae”. In a discussion paper by HWWA (2004) on financial integration, the need to develop robust securities and settlement infrastructure was concluded to be the key to efficient financial market integration in Europe (Carvalho 2004). With this in mind, this paper therefore focuses on analysing the role of the institutions that are involved in the clearing and settlement of securities among security traders, namely custodial services companies. Carvalho (2004) argues that an efficient clearing and settlement

system is defined by its ability to safely transfer security ownership against payment for the same at a lower risk and transaction cost (Carvalho 2004).

1.1 Background to the Study

Prior to 2012, the securities custodial services sector was highly fragmented if not invisible in Zimbabwe. This was because of weak regulations that were in place which allowed stockbrokers to also act as custodians as well as allowing the use of nominee accounts. This allowed stockbrokers to record clients' securities in the name of the nominee company as opposed to the rightful owners of the securities. The year 2010 came with key sweeping changes aimed at sanitising securities trading processes in Zimbabwe. The Securities and Exchange Commission of Zimbabwe (SECZ) issued a directive prohibiting stockbrokers from doubling as custodians of securities and requesting that all scrip (share certificates) be transferred to licenced custodians in terms of Section 38(1)(a) of the Securities Act [Chapter 24:25] and the Third Schedule of the Securities (Registration, Licensing and Corporate Governance) Rules, 2010 (Government of Zimbabwe 2010). The same directive also required that all scrip that had been registered in the name of nominee companies be registered in the names of the individual clients who owned the securities. In addition, licencing requirements were also gazetted with aspiring custodians being expected to have a capital base of \$500,000 all in an effort to eliminate undercapitalised stockbrokers and boosting investor confidence thereby reducing chances of them liquidating and possible losses by investors.

Portfolio investors are interested in the safety of their assets or at least an adequate compensation before they can make an investment (Goldstein & Razin 2006). Thus, the initiatives taken by SECZ are just the beginning of a long journey towards matching the international best practice as far as the operations of custodial service companies are concerned. Table 1.1 shows that the trade statistics on the Zimbabwe Stock Exchange (ZSE) have been on the decline in terms of total volumes traded, total number of transactions, number of listed companies and number of traded companies between 2010 and 2013. This is simply a reflection of shrinking portfolio investments as a result of the opacity and inefficiencies that characterised securities trading, clearing and settlements of security as well as safekeeping of scrip.

Table 1.1 Trading Equity Statistics on the ZSE (2010-2013)

| Indicators | 2010 | 2011 | 2012 | 2013 |
|--|-------------|-------------|-------------|-------------|
| Total value traded (\$ millions) | 392 | 476 | 448 | 486 |
| Total volume traded (billions) | 6.80 | 4.61 | 3.51 | 2.99 |
| Total number of transactions | 39,655 | 30,983 | 21,426 | 19,000 |
| Number of listed companies | 79 | 78 | 79 | 67 |
| Number of traded companies | 76 | 74 | 70 | 63 |
| Market Capitalization end of year (billions) | 3.88 | 3.69 | 3.964 | 5.203 |
| Market Capitalization as % of GDP | 42.75 | 36.29 | 35.26 | 44.75 |

Source: African Securities Exchanges Association (2014)

The table below shows calculated annual growth for each of the measures using the statistics in table 1.1 above using year 2010 as the base year. It also shows the geometric mean and the overall growth percentage for the period 2010-2013.

Table 1.2 Analyses: ZSE Trading Statistics

| Indicators | 2010 Base | 2011 | 2012 | 2013 | Mean | Growth Rate |
|------------------------------|------------------|-------------|-------------|-------------|-------------|--------------------|
| Total volume traded | 100% | 68% | 76% | 85% | 76% | -24% |
| Total number of transactions | 100% | 78% | 69% | 89% | 78% | -22% |
| Number of listed companies | 100% | 99% | 101% | 85% | 95% | -5% |
| Number of traded companies | 100% | 97% | 95% | 90% | 94% | -6% |

Source: African Securities Exchanges Association (2014)

The above analysis Table 1.2 indicates a significant decline in level of securities trading activities in terms of trade volumes and number of transactions. The statistic above reveals an unfavourable liquidity state of the ZSE. Previous studies have suggested that the higher the trading volumes and trading frequency the more liquid market trends though in some cases volumes and frequency implied price volatility and lower liquidity (Fleming 2001). The 24% and 22% decline in volume traded and transactions respective indicates a decline in trading activity which is supported by a decline in the number of listed companies which are the market participants. Liquidity has been defined as the ability of a market to facilitate quick trade at a low cost. (Chordia, Sarkar & Subrahmanyam 2003). Based on this definition and the information above the ZSE is lacking liquidity. The firming of the market capitalisation accompanied by reduced trading activity might be driven by market players holding onto blue

chip (high value) counters creating artificial scarcity thereby pushing their prices further upwards.

Following further analysis of the trading trends at the ZSE, there is an interesting and opportunistic trend which has emerged. Table 1.3 shows a trend where despite the deindustrialisation which Zimbabwe has been underdoing since dollarisation there has been a notable decline in local portfolio investors accompanied by an increase in foreign portfolio investors between 2010 and 2013 on the ZSE.

Table 1.3 Investors Type: Foreign vs Local Investors on the ZSE

| Type of Investors | % of the Total Value traded (USD\$) | | | |
|-------------------|-------------------------------------|-------------|-------------|-------------|
| | 2010 | 2011 | 2012 | 2013 |
| Foreign Investors | 23% | 36% | 41% | 50% |
| Local Investors | 77% | 64% | 59% | 50% |
| Total % | 100% | 100% | 100% | 100% |

Source: African Securities Exchanges Association (2014 Yearbook)

The data presented in Table 1.3 presents a situation where the composition of foreign investors increased by 27 percentage points to 50% of total investors while that of local investors declined by 27 percentage points between 2010 and 2013 to 50% of total investors. The influx of foreign investors grow from the early years of dollarization onwards suggesting a confidence associated with the stability proffered by the multicurrency regime while a decline in local investors could be attributable to the liquidity crunch and economic hardships prevalent during the same period. Such developments present an opportunity for the authorities in the financial services sector to put in place measures that will increase the competitiveness of the Zimbabwe stock market.

The strength and general stability which characterises the United States Dollar, which is currently the main trading currency in Zimbabwe, presents an opportunity to lure potential foreign portfolio investment which ultimately induces trade and liquidity on the ZSE and possibly in the economy at large. There are no meaningful changes that can be made to increase trading at the ZSE and the influx of foreign portfolio investment however, without

first analysing the key supporting function namely custodial services which deal with the safekeeping, clearance and settlements of investment securities.

1.2 Problem Statement

Efforts to stimulate economic recovery in Zimbabwe have for many years been centred on the need to attract Foreign Direct Investment (FDI). In order to achieve this, millions of dollars have been spent on infrastructure developmental projects between 2010 and 2015 with total annual capital expenditure averaging 3.7% of national GDP (Monyau & Amarakoon 2014) . This approach has proven to be capital intensive and its success will take as long as is required to gather the necessary resources needed to build the physical infrastructure. There is an alternative approach, however, which has the potential to achieve similar developmental goals within a shorter time span and with fewer resources namely, through attracting foreign portfolio investment. Rather than focusing on capital intensive physical infrastructure, efforts to improve foreign portfolio investment are focused on the development of a robust financial infrastructural framework to maximise efficiency as well as encouraging the adoption of high standards of corporate governance and competitive business models to enhance investor confidence as way of attracting foreign investment.

The purpose of this study was to assess the role of financial custodians in prompting portfolio investment in the Zimbabwean stock market. This will also help give insight into the spill-over benefits the link that might exist between the two in view of finding a lasting solution for the prevailing liquidity crunch.

1.3 Research Objectives

The objectives of the study were to

- i. Examine the effectiveness of the local custodial service delivery system in terms of service diversity, efficiency and attractiveness to foreign portfolio investors.
- ii. Establish the role of custodians in mitigating risk in securities trading and hence stock market attractiveness to foreign portfolio investors.
- iii. Determine the importance of global integration in the custodial services business in attracting foreign portfolio investment.

- iv. Recommend the areas of priority in enhancing effectiveness among financial custodians to attract portfolio investment in Zimbabwe.

1.4 Research Questions

The study sought to answer the following questions;

- i. How effective is the local custodial service delivery system in terms of service diversity, efficiency and attractiveness to foreign portfolio investors?
- ii. How does the custodial service industry help mitigate risk and enhance stock market attractiveness to foreign portfolio investors?
- iii. What role does global integration of custodians play in attracting foreign portfolio investors?
- iv. What can be done to improve their competitiveness and effectiveness in attracting portfolio investment?

1.5 Research proposition

The study proposes that the ability of local custodians to mitigate securities trading risk and improve trading efficiency will increase foreign portfolio investment into the Zimbabwean market.

1.6 Delimitation of the study

The study will look at the role of custodians in promoting portfolio investments in Zimbabwe and will focus on companies operating in the custodial services industry, stock broking and financial asset management. The study will be a cross sectional study due to the timeframe within which this study is to be conducted and completed. It will therefore not focus much on the developmental history of the custodial services sector but instead on the current state of things and known global trends.

1.7 Significance of Study

By taking a holistic approach in analysing the sectors that normally expose the invested assets to various types of risks this study provides a trail aimed at plugging leakages in the most critical areas of portfolio investment. The study seeks to get expert options from the asset managers who make investment decisions on behalf of investment clients, then briefly looks at the stock brokers who receive instructions from the asset managers on buying and selling of the investment assets and finally places extensive focus on the custodians who do the

clearance, settlement and safekeeping of the investment assets namely scrip. An in-depth study has been chosen to gather the relevant details on the custodians of investment assets and no such study has been conducted as yet within the Zimbabwean context and in connection with foreign portfolio investment. This study will give the needed insight to policy makers in the financial services sector to rethink their processes and possibly revise them to enhance their competitiveness to attract foreign investment inflows. The study will also contribute new insights to academic literature in the area of custodial services and how it links to portfolio investment in a less developed country like Zimbabwe.

1.8 Chapter Summary

The study is meant to analyse the role of custodians in promoting foreign portfolio investment in Zimbabwe. This came out of the need to explore an alternative route in the quest for attracting foreign investment. The object is mainly to assess the effectiveness of the service delivery system of financial custodian, establish their role in risk mitigation and examine the importance of global custodians in linking local custodians to the global market all with the aim of attracting foreign portfolio investors. The study is meant to bring new insight with regard to dealing with the prevailing liquidity challenges as well as opening a door for lower cost capital to revive the industries among other things in Zimbabwe.

CHAPTER 2

LITERATURE REVIEW

2.1 Introduction

In view of the objectives and research questions posed in the previous chapter, this chapter focuses on interrogating various literature sources on custodial services, investment also narrowing down to foreign portfolio investment. The chapter also focuses on bringing to light the relationship that exists between competitive operations and administration of custodial services and its ability to attract foreign portfolio investment to the host country. A comparative approach is taken in exploring the recommended international best practices and how the adoption of such has made a difference in developing economies.

The collapse of one of the world's largest financial institutions, Lehman Brothers at the onset of the global financial crisis gave enough evidence on the critical role which custodial services and rules governing their operations play in financial market risk. The lack of adequate investor protection laws and failure to segregate assets held in custody as well as the use of re-hypothecated or borrowed securities as collateral among other things led to the insolvency of the Lehman Brother which triggered a contagion effect across European and American financial markets thereby marking the beginning of the 2008 Global financial crisis (Singh & James 2009). The extent of losses and market failures that characterised the 2008 Global Financial Crisis calls for serious restructuring and reengineering of processes in the securities market to ensure that history is not repeated.

In view of losses that were incurred by investors focus has increasingly been placed on reducing the rate and extent of re-hypothecating of securities as well as ensuring that there is segregation between securities held in custody and those held as collateral so as to restrict prime brokers' claims over assets held in custody. It has however been argued that although the move to reduce security lending helps reduce counterparty risk it also tends to reduce market liquidity (Singh & James 2009). The following sections define and explore the functions, risks and developments in the custodial services industry as observed in the developed countries to obtain a basis for appraising the local Zimbabwean market and the potential which the industry has in attracting portfolio investment (which is discussed later in the chapter).

2.2 Defining Custodial Services

According to the Hogan (2012) custodial services are services offered to holders of financial investment assets which among other things involve safe keeping of title documents, settlements for dealings involving financial assets and analytical reports pertaining to the assets held. The major clients for custodial services include, investment managers, retirement plans, mutual funds, insurance companies, endowments and other public and private clients among others (Hogan 2012). Chan, Fontan, Rosati and Russo (2007) also highlight the need for document (certificates of value) security as the initial reason for the establishment of custodial services operating through investment banks, brokers and commercial banks (Chan et al. 2007). Custodial services are normally provided by commercial banks, stock brokers as well as investment banks. The assets that are entrusted to custodians are usually financial instruments such as equity securities or money market securities though physical assets such as precious metals and properties can be included (IOSCO 2014). Below is a discussion of some of the main functions of financial custodians.

2.2.1 Global Developments in the Custodial Services Industry

The original function of custodians namely safekeeping of physical security documents has been overtaken by technological innovations namely immobilisation and dematerialisation of securities. The concept of certificate immobilisation and dematerialisation emanated from the realisation by stock market authorities in developed countries in the 1970's that the manual transfer of physical share certificates was beginning to interfere with increased trade volumes in shares. Certificate immobilisation hence required all financial intermediaries dealing in stocks to deposit share certificates with a central depository which would then account for transfer of traded shares through book entries done by the depository without physical movement of certificates (Kanzaki 1981). Dematerialisation however goes a step further by destroying the physical share certificates and substituting them with shares electronic form held in an account held by a central depository (Katerere 2014). Although dematerialisation and immobilisation of certificates through a central depository has been hailed for increasing security trading efficiency, participation and reducing trading risk by Katerere (2014), Kanzaki (1981) argues that immobilisation created unnecessary red tape between the shareholders and the issuing firm thus compromising effective communication between the two and creates possibility errors and abuse inherent in such indirect communication channels.

The role of custodians in settlement and asset administration services however continues to dominate custodial services functions. There are three major steps in a securities trading transaction namely trade execution, when buyer and seller conclude a deal, secondly is clearing, which involves matching and confirmation of trade transaction details, and finally and most important, settlement which sees the transfer of funds in exchange for securities and hence transfer of risks and rewards (Goldberg et al. 2002). The settlement process can be quite complex when it involves cross border transaction particularly those involving portfolio investors and this is where the robustness of custodial services becomes important. In this case the investor needs to link up with another country's depository and this can be achieved through engaging the services of a local custodian or via a global custodian which are member of the central depository in the host country (Goldberg et al., 2002).

Global custodians help create the cross border market networks that are crucial to sustain foreign portfolio investment. However before entering new markets, global custodians look for key market and sub-custodian characteristics namely the degree of automation of settlement processes, the tax regime, exchange control regulations, efficiencies in information dissemination, market liquidity and depth, plans to further develop systems, as well as the robustness of the control environment and financial position of the sub-custodian (Hogan 2012). Market liquidity refers to the ease with which securities can be sold at minimum transaction cost (Chordia, Sarkar & Subrahmanyam 2003). Market liquidity is then further defined in terms of tightness, which refers to existence of low costs (Fleming & Garbade 2003), immediacy which measure the efficiency of the trading and settlement system (Botha 2008) as well as market depth which refers to the market's ability to absorb large orders with minimal effect on the security prices (Sarr & Lybek 2002). The mention of the settlement system also underscores the role that can be played by custodians in determining the attractiveness of securities market.

The custody business has over the years been largely skewed towards value addition and has also gained credibility for its ability to promote security trading efficiency as well as effective risk management (Superreview 2011). This value addition has been in the form of performance reports and portfolio risk monitoring and analysis. Chan et al. (2007) describes the custodial industry as one whose success hinges on heavy and continuous investments in technology. Such investment outlays have an effect of heightening fixed costs thereby making it impulsive to aim for higher transaction volumes to accrue economies of scale in the

end (Chan et al. 2007). Goldberg et al., (2002) further explained that high overheads are common in the custodial business owing to the need to invest in technology, robust communication networks, and the need to constantly change processes and infrastructures to align with legislative changes.

In a bid to lower fixed costs European Union countries are opting for consolidation of systems and standardisation of legal frameworks and processes. According to Pagano, Roell, and Zechner (2001), the low liquidity and higher transaction costs which characterised the European exchanges during the late 1990's saw them failing to attract new foreign listings as investors preferred the American exchanges where such costs were estimated to be three times lower (Pagano, Roell & Zechner 2001). In a study which analysed currency trading outsourced to custodians by asset managers it was observed that due to lack of transparency custodians often charge extremely high margins taking advantage of the fact that transaction costs are not disclosed beforehand to probe negotiations (Osler, Savaser & Nguyen 2012). They recommended that the establishment of an efficient and transparent trading platform for custodians is crucial to promote confidence and fairness.

2.2.2 Services Provided by Custodians.

The core services provided by custodians include, trade settlements, cash investments for clients, interests and dividend collection, security position pricing, administration of corporate actions, record keeping and asset reporting (Hogan 2012). The services provided by custodians vary depending of minimum regulatory requirements and contractual arrangements with clients. The other services also include value adding services such as security lending, investment portfolio measurement and appraisal and cash management. Furthermore a custodian can be empowered contractually by asset managers and clients to oversee portfolio asset trading routines as well as adherence to client instructions by asset managers so that they keep or sale assets as agreed with clients. They can also extend to valuation of investment portfolios independent of the asset manager as well as appraising the performance of asset managers against expected portfolio returns (OXERA 2002).

Custodians also provide a wider range of services to corporates acting as corporate trusts and offering shareholding services which include rights issues, share warrants and swaps, as well as administering share buyback schemes (Chan et al. 2007). Custodians can also be

contracted to track share movements and shareholder profiles to keep a company abreast with the dynamics surrounding the ownership of its shares. They also play a role in facilitating annual general meetings for corporates by handling regulatory issues and arranging for ballot and proxy voting as well as distribution of resolutions. Custodians also offer employee share option scheme administration services through managing share registers and managing the exercising of share options and in some cases even financing similar share purchase arrangements. (Chan et al. 2007).

Custodians also play a crucial role in facilitating repurchase agreements (repos) and security lending. A repo is an agreement to sell securities now only to buy back the same on a future date and at an agreed future price (Garbade 2006). Security lending is the temporary swapping for securities for pledged collateral which can be cash or another security (Dreff 2010). Hogan (2012) also indicated that through security lending custodians offer its custody customers an opportunity to earn additional income through lending custody assets to approved borrowers for an agreed fee. This availability of security lending function helps create liquidity through enhanced price discovery in markets as well as extending available financing options hence better financing strategies (Dreff 2010). However research around the origins of the 2007-2008 global financial crisis points to unregulated extensive securities lending and collateralisation of securities which was the effect of increasing counterparty risk.

2.2.3 Risks in the Custodial Industry

The main risks that are associated with the custody business are classified into reputational, operational (transactional), credit, compliance and strategic risk (Hogan 2012). However global custodians are exposed to additional risks compared to single market custodians due to the need to deal with additional factors such as different regulations, varying levels of automation, exchange control restrictions varying communication efficiencies across foreign markets (Hogan 2012). According to ISSA (2001) global custodians are exposed to much more risks namely business risk, counterparty risk, country risk, credit risk, liquidity risk, market risk, operational risk, settlement risk systemic risk and transfer risk.

2.2.3.1 Operational Risk:

Operational risk is the most prominent risk in this sector owing to the high traffic of transactions on a daily basis. It entails the likelihood of business losses as a result of error, frauds, product attributes and informational issue. It also embodies product development issues, systems, processes, controls and product complexity (Hogan 2012). Chan et al., 2007 identifies this risk as one that emanates from inadequacies in processes, people, systems and other external factors. Hogan, 2012 argues that in most cases custody related losses emanate from errors associated with corporate actions, settlements, foreign exchange conversions and book entries. Chan et al., 2007 highlight that operational error such as miscommunication and misinterpretation of information normally result in serious delays, claims and fines for non-compliance and loss of value suffered by clients. Some errors even cause over/ under valuation of funds thereby distorting the basis upon which performance is measured.

Errors in settlement also create delays which cause losses in the form of opportunity cost of funds not settled timeously. This normally results in compensatory claims from the affected counterparty. Robust infrastructure has managed to reduce settlement related risks through innovative and efficient systems that settle by way of delivery versus payment (DVP). Inadequacies in the form of poor query track processes and follow-up procedures and delayed communications regarding failed transactions also result in market imposed penalties. Errors in fund accounting also result in asset valuation errors as well as pricing errors which when discovered will generate claims (Chan et al. 2007). Information technology risk can come in the form of weak system access security which could propagate frauds and hence compromise data integrity, systems which heavily rely on manual input giving room for human error and system failure which may result in incorrect asset value, tax, and dividend computations or even result in custodian failing to timeously act on corporate events (IOSCO 2014).

2.2.3.2 Credit Risk

This is the risk that one of the parties to a contract might fail to comply with agreed financial obligations. This has largely been eliminated through the adoption of DVP settlement processes. However credit risk is present where there are security lending arrangements. Global custodians also face credit risk when they deal in markets which do not use DVP for their settlements (Hogan 2012). The possibility of a counterparty going bankrupt or

liquidating is also another source of credit risk (ISSA 2001). Related to credit risk in global custody operations are liquidity and counterparty risk and to some extent country risk. Liquidity risk entails delayed fulfilment of contractual obligations while counterparty risk means outright failure to meet the obligation either willingly or due to constraints which could further be linked to market risk which arises from fluctuating prices and exchange rates. Country risk which may result in transfer risk also has a role to play since a foreign government might institute regulatory changes in the form of exchange controls which restrict conversion and transfer of funds abroad (ISSA 2001).

2.2.3.3 Reputational Risk

This is risk that accrue from public perceptions held again a custody service provider and this has the effect of shrinking the customer base, generate litigations as well as penalties in the form of fines. This risk is inherent at every point at which the business interfaces with the public and normally arises when the business fails to perform up to expectations or as promised (Hogan 2012). The risk of losing customer base is described as business risk or competitive risk by ISSA (2001) and is often triggered by dwindling profit margins, failure to adopt more effective business models and the introduction of laws which compromise business viability. Reputational risk is largely driven by operational or transactional risk which could be as result of errors in security valuations, pricing of investment units, non-adherence to investment guidelines, misinformation as well as delayed execution of instructions which prejudice clients and result in claims for financial losses incurred (Chan et al. 2007).

2.2.3.4 Strategic Risk

This is a risk which is based on the business model adopted by a custodian and its adaptability to changes in the competitive business environment. The availability of financial resources, the effectiveness of communication networks and operating system, managerial innovativeness and motivation has a bearing on the sustainability of custodian's strategy in the face of competition (Hogan 2012). Chan et al., 2007 also highlight that the custodians that do well are those that have sufficient economies of scale to sustain the narrowing margins that are coming as a result of fierce competition resulting in business consolidations. Hogan, 2012 also underscores the need for custodians to continuously invest in more efficient systems and technologies if they are to remain afloat.

2.2.3.5 Legal Risk

This is the risk that the counterparty may fail to exercise rights assumed at the point of contracting. The different jurisdictions of law as custodians continue to transact across borders mean that due to differences in interpretation, application and adequate provisions of laws the enforceability of laws might not be easy and straight forward. The issue collateral liquidation in the case of a defaulting party has become a common problem especially when it involves cross border transactions (Chan et al. 2007). The other source of legal risk is the treatment of assets held in custody in the event of insolvency of the custodian. It is important to note that global custodians and cross border investors namely portfolio investors need to understand legal provisions in their countries where their assets are held in custody to avoid such legal risks. In this era of security dematerialisation some countries are yet to incorporate laws that recognise securities in electronic form (Benjamin 1996). This risk also encompasses compliance risk since legal issues have compliance implications.

There are also financial risks that are related to the abovementioned legal risks and these are more pronounced where the custodian is also a bank and hold cash accounts for its custody clients. Just like ordinary depositors in a bank, the deposits in custody customers' cash accounts also form part of the custodian's balance sheet which because subject to assessment in cases of liquidation of custodian resulting in financial loss to the clients. However the custodian is non-banking, there are laws that enforce segregation of such deposits from normal deposits thereby protecting clients in the case of liquidation. Securities held in custody are generally protected by law in many jurisdictions and do not form part of the custodian's securities. Some jurisdictions give custody clients the right to their assets held in custody while some simply give them right of claim on the custodian which tend to expose them in case of bankruptcy (Chan et al. 2007).

2.2.3.6 Systemic Risk

A systemic risk arises where failure by a particular institution to meet its contractual obligations will affect other parties' ability to fulfil the obligations as well owing to the intertwined relations that exist within markets (Chan et al. 2007). The ISSA (2001) calls it the chain reaction and this can be caused by disruptions of third party services namely central depositories as well as system failures. In some countries regulations are being put in place to assess asset managers and custodians' ability to cope with systemic risk (SASB 2014). The

failure by one custodian to meet its obligations when they fall due to other counterparts means that the recipient counterparts who will be expecting delivery on a particular day for on-ward passing will also fail everyone down the chain thereby creating a liquidity problem downstream (Chan et al. 2007).

2.2.4 Custodians and Investor Protection

The collapse of big institutions like Lehman Brothers and MF Global and the Madoff fraud brought to light the risk that can result from poorly regulated entities and the effect that conflict of interest can have in asset management (IOSCO 2014). In the United States (US) laws have already been put in place to impute fiduciary duties upon asset managers and custodians following the consequences of the 2007-2008 financial crises with view of protecting investors. These fiduciary duties require asset managers and custodians to act in utmost good faith, disclose conflict of interest as well as avoiding actions that are meant to benefit a third party. They also require that asset managers act with due care and exercise thoroughness and display high levels of skill in handling transactions as well as in administering their advisory role (SASB 2014).

Where a custodian is empowered by custody clients contractually to assume an oversight role over the operations of asset manager's greater protection is assured. This role can then introduce an independent check in the operations of asset managers (namely asset valuations and asset holdings) to curb fraud and align asset managers' behaviour with the interest of the investors. Custodian functions if performed diligently can potentially minimise losses that may be triggered by errors originating from asset managers. Custodians also protect investors by compensating investors where valid claims arise (OXERA 2002).

One area of concern regarding the custody of Collective Investment Schemes (CIS) or mutual fund assets has been the risk of mixing these assets with those belonging to other clients or even with custodian assets. This prompted authorities in various jurisdictions to put in place a requirement to protect such assets by segregating them into omnibus accounts in view of the size of such investments. This measure enables easy identification of CIS assets in the event of bankruptcy of custodian as well as preventing custodians from using these assets to settle other obligations (IOSCO 2014).

In most cases self-custody of huge investments like mutual funds is prohibited, that is, the company which created the investment vehicle is not allowed to keep such assets under its custody in order to eliminate conflict of interests. Rather they are required by law to appoint a third party custodian. However in cases where self-custody is allowed the entity is can only keep certain types of assets which should be administered separately by its subsidiary. With self-custody also come an additional disclosure requirement, addition capital requirement, more supervision, need to physically segregate mutual fund assets as well as the need to engage independent auditors to regularly verify these assets. (IOSCO 2014). In a bid to protect mutual fund assets, some jurisdictions require custodians to perform an oversight role over mutual fund assets. This oversight role entails appraising asset managers' investment decisions against investment set guidelines, monitoring the sale of assets, redemption cash flows and valuation of assets under management (IOSCO 2014).

2.2.5 Cross- Border Investments and Settlement Integration

The competitiveness of the custodial business mainly hinges on its ability to contain costs through economies of scale. One way of creating the required volume thresholds is through facilitating cross border security trade as mentioned above. According to Osler et al., 2012 there has been significant growth in cross border or foreign portfolio investment I recent years as investors seek higher returns and greater portfolio diversification. Such growth has among other things been sustained by the role which global custodians play in creating cross-border linkages as well as closing the information gap between aspiring investors and their investment destinations. The complex settlement arrangements that are involved in cross-border settlements also come with costs hence the drive towards system integration and consolidations main in Europe (Goldberg et al. 2002).

According to Goldberg et al., 2002 there are four main options that can be adopted to smoothen cross border settlement which will in turn impact positive on foreign portfolio investment namely, the use of central counterparties, linkages between central depositories, mergers of central security depositories and mergers of exchange. Central counterparties enable the netting of dealer positions and hence risk exposure while cross border linkage would enable foreign security exchange directly between central security depositories thereby removing intermediary costs. The merging of depositories would eliminate duplicate

functions and costs thereof as well as settlement timing differences while exchange mergers would significantly reduce trade execution costs (Goldberg et al. 2002).

In response to the growth in cross-border foreign portfolio investments the custodial business has evolved in three ways to capture this opportunity namely through single market, multi-direction and global custodial services (Chan et al. 2007). Single market custodians concentrate on local services and foreign inflows while multi-market custodians penetrate into other markets to register their presence so as to better understand foreign markets and develop wider linkages with investors. Global custodians are normally single custodians that have spread their services extensively into multiple global markets usually to follow their domestic investments abroad. Their presence can spread to as many as 100 accesses to foreign central security depositories through appointment of sub custodians that are affiliated to them.

To a large extent the aftermath of the global financial crisis has left a legacy of risk aversion, meaning that before an investment commitment investors need crucial decision information about various markets, available investment instruments, return and liquidity of such instruments and this information is sought from custodians (Standard_Bank 2013). Key issues required for a custodian to attract investors include financial stability, good credit rating, affiliation to a multinational company, provision of 24 hour services to cater for different time zones and ability to create a multi-lingual communication platform with diverse investors. According to Chan et al., 2007, institutional investors are the main customers for global custodian mainly because of the need for consolidated reporting on their investment assets that are scattered across foreign markets. To a large extent this helps to eliminate the information asymmetry problem by providing the much needed transparency which boosts investor confidence.

2.3.0 Investment Dynamics

According to Chaudhry, Farooq and Mushtaq (2014) an investment is defined as a current sacrifice of money or funds by postponing consumption into the future through purchasing financial instruments in the hope of gaining profitable returns by way of interests or asset value appreciation in the future (Chaudhry, Farooq & Mushtaq 2014). However in the context of international investment agreements the term investment is loosely used in some treaties to

cover every kind of asset and any kind of asset. Most treaties often clarify further by including a list of such assets which often include movable and immovable assets, company shares, claims value creation, intellectual property rights, business secrets or formulae, technical process reengineering and business concessions among other things (IISD 2008). In addition the definition of investment can be further refined by use of criteria based on things like capital size, risk involved, and duration of investment as well as the significance of this contribution towards development (UNCTAD 2011).

2.3.1 Foreign Portfolio Investment and Foreign Direct Investment

Chaudhry, Farooq and Mushtaq (2014) use the term capital inflows in place of investment highlighting that these come in two forms namely foreign aid and foreign private investment. The latter falls into two categories namely foreign direct investment and foreign portfolio investment. They define portfolio investment as a collection of liquid financial assets held by an investor over a short to medium term. These assets may include debt instruments, government or corporate bonds, or investments in funds namely mutual funds and wealth funds (Chaudhry, Farooq & Mushtaq 2014). Goldstein and Razin (2006) distinguish foreign direct investment as one that avails the opportunity for investors to have both managerial control and ownership of an investment or firm in the destination country (Goldstein & Razin 2006). They further stipulate that in the case of portfolio investment there is ownership without direct control since control is delegated to managers on the firm which tends to create an agency – principal problem where the interests of the managers might conflict with those of the owners of the business.

2.3.2 Global Developments of Portfolio Investment

The increased prospects of international portfolio investment in emerging markets date back to the late 1980s when financial markets slowed down especially the USA the fall in stock prices. These developments forced mutual fund managers to look for alternative investment markets in the emerging markets and the rest of the world for better returns. This driver towards emerging markets emanated from a number of developments namely the liberalisation of financial markets in the late 1970s in developing countries and later through the demise of communism (Grabel 1996). Portfolio investment inflows have been argued to be a cheaper source of capital in developing countries and a means to improving a country's adverse balance of payment position. Grabel (1996) also suggests that emerging economies

arguably prefer portfolio investment to foreign direct investment which they consider a serious threat to national sovereignty and control.

The debate around the suitability of either foreign portfolio investment or foreign direct investment as a way of stimulating developing economies dates as far back as the 1970s where Wolff argues that foreign direct investment through powerful multinational corporations was degenerating to a point where it was compromising national sovereignty in destination countries through unfair use of their financial muscle to influence policies to their own advantage (Wolff 1970). Evaluating borrowing as an alternative source of funds for emerging markets Grabel, 1996 made the assertion that borrowing from commercial banks was equally constraining as any sizable amount of lending is normally accompanied by restrictive and burdensome conditions on governments in the developing countries leaving portfolio investment a better alternative for attracting capital to induce economic development (Grabel 1996). In support of this notion WIDER (1990) says portfolio investment to a greater extent helps developing economies overcome the above mentioned pitfalls of commercial loans and foreign direct investment in attracting foreign capital. (WIDER 1990). Before going further into the discussion it is imperative that a clear distinction be made between foreign portfolio investment and foreign direct investment to have a clear base of argument.

Gozgor and Erzurumlu (2010) in their study of the cause-effect relationships between foreign direct investment and the fluctuating behaviour of portfolio investment in Turkey, Russia, Czech Republic and Poland conclude by affirming the link between the two. They demonstrate that foreign direct investment helps promote foreign portfolio investment by narrowing information gap between the source and destination countries thus partly reducing the information asymmetry problem which tends to boost portfolio investor confidence (Gozgor, 2010). However Dua and Garg (2013) argue that capital inflows especially into emerging economies like India are partly a result of arbitrage opportunities in which investors seek favourable returns in view of the investment climate in the host country in term of stock market indices, foreign exchange and interest rate differentials and volatility and gross domestic product growth among other things. It is further argued that if investor intentions are highly speculative, sudden reversals in capital inflows can be detrimental to the overall balance of payment of an economy (Dua & Garg 2013).

2.3.4 Factors attracting Foreign Portfolio Investors in Emerging Markets

In a case study on capital flows and financial assets in the Philippines, Gonzalez (2009) acknowledged the high influx of capital flows to emerging markets from developed countries. He singled out two major pull factors; namely the fall in investment interest returns in developed countries as well as the notable growth in the depth of financial markets in the emerging markets (Gonzalez 2009). Gray and Talbot (2006) define market depth as a stage where the existence of large orders in the market does not result in undesirable stock price volatility in which case the market has the capacity to absorb the demand without abnormal fluctuations. Such impact can also be mitigated through trading efficiencies that promote high trade execution frequencies (Gray & Talbot 2006).

It is important however to underscore the fact that the capital flows to the emerging markets are not a result of a random selection of new investment locations but a result of serious implementation of deliberate and well thought strategies to attract capital inflows. In a study on corporate bonds in Malaysia (Ibrahim & Wong 2006) authorities in the Malaysian financial markets embarked on an intensive financial infrastructure development programme which resulted in the computerisation of trading platforms. In addition a real time paperless settlement system, RENTAS (Real Time Electronic Transfer of Funds and Securities) was established to promote fast and efficient securities trading as well as online transaction platforms to enhance transparency on debt security trading transactions.

In 2004 Malaysia implemented the Institutional Securities Custodian Programme (ISCP) to facilitate lending of securities to the central bank which effectively boosted liquidity by further securing the central bank's borrowing position and reducing risk of default and hence risk premium. In the same year an internet based Islamic banking platform for Islamic bond market to promote quicker information dissemination on financial securities was launched (Ibrahim & Wong 2006). These and other measures resulted in an accelerated growth in private debt securities of 4485% from MYR4.1 billion in 1989 to MYR 188 billion in 2004 with corporate bonds constituting 37% of the country's gross domestic product (GDP) (IMF 2005).

Interconnectivity and interoperability of trading platforms and systems as well as the harmonisation of cross border legal provisions is also crucial to portfolio investment expansion as indicated in a compliance report on financial markets infrastructure (CPSS-

IOSCO Principles) (IMF 2013). The Malaysian RENTAS system also supports and facilitates interconnectivity with other trading platforms internationally through DVP (Delivery Versus Payment) and PVP (Payment Versus Payment) protocols. The former entails simultaneously matching the delivery of security with payment instructions within local markets while the latter involves the matching of payments and instructions that have to do with a trade in different currencies across borders to synchronise and manage foreign exchange fluctuations (IMF 2013). In view of this, the Hong Kong Monetary Authority (HKMA) is convinced that even the most advanced and sophisticated systems needs to link up with system in other countries to accrue relevance in global trade (Kame 2014). By implementing internationally renowned standards and platforms such as DVP and PVP a country enhances attractiveness to investors and affirms its safety in trade settlements.

In a study on Hong Kong's settlement systems the need for settlement efficiency drove the country into establishing a United States of American dollar (USD) RTGS (Real Time Gross Settlement) system to better handle USD transactions in the Asian time zone in August 2000. This was merely four years after the country established its own RTGS system in 1996 motivated by the need to reduce settlement risk on high value transactions thus underscoring the need to improve infrastructural capacity to attract and handle greater capital inflows and trade (Kame 2014). In Sub-Saharan Africa, foreign direct investment (FDI) seems to be more pronounced in the countries with rich mineral wealth while portfolio investment is thriving in countries with well-developed financial infrastructure and quality institutions namely South Africa, Nigeria, Ghana, Kenya and Tanzania (Marwa 2014).

In contrast to the emphasis on infrastructural development, Dua and Garg (2013) place more emphasis on economic factors in both the host and source countries as having greater influence on portfolio investment decisions. They suggest that investors undertake a cost-benefit analysis to assess the opportunity costs of investing any a particular location. They achieve this through risk assessments and risk rating to evaluate the creditworthiness as well as the risk-reward trade-offs embedded in an investment opportunity. The two also place critical value on assessments and appraisal of economic indicators and the trends thereof to assess the sustainability of an investment opportunity over time (Dua & Garg 2013).

Lucas (1990) initiated a debate on capital investment flow that opposed the neoclassical view that capital always flows from rich to poor countries unless equilibrium is reached. The

latter's argument was that the high demand for capital in the capital scarce poor countries would mean that such countries are prepared to acquire additional capital at a premium resulting in higher returns for the developed country-based investors, hence the downhill flow of capital. Lucas however undertook an empirical study on the USA and India and concluded by questioning the validity of the neoclassical view by explaining the possibility of an uphill flow of capital firstly in terms of fundamental differentials in production factors, technological innovation, governance and quality of institutions. Secondly he explained in terms of market imperfections which could be in the form of risk of nationalisation and information friction (Lucas 1990). In summary this argument suggests that it is up to the poor country to optimise its factors of production, create innovative technologies, improve its governance and quality of its institutions as well as setting up the infrastructure that promote efficient dissemination of information to stimulate the downhill flow of capital.

Marwa (2014) highlighted that Sub-Saharan Africa happens to be doing well in attracting capital flows in the form of remittances. He suggests that this opportunity needs to be captured through the use of innovative incentive mechanisms such as creating sovereign bonds as in the case of Nigeria, Gabon and Ghana, issuing of Diaspora bonds and development of financial markets and institutions (Marwa 2014). This implies that in a way such initiatives can generate confidence among international capital market players. Through the upgrading of financial systems and standardisation of processes in line with international best practice an economy can change investor perceptions for its own good.

2.3.5 Conclusion

In conclusion the above discussion points to the fact that, portfolio investment is on the rise and will continue as such in the foreseeable future mainly being driven by the forces of globalisation, cross border infrastructural developments, improved communication technologies and the search for higher returns. The rise in the aged population in most developed countries has spurred growth in pension, retirement and mutual funds in already saturated markets where returns are relatively low. This has prompted institutional investors to target emerging markets and Africa in view of the high return offerings albeit the political risks inherent in these destinations. It is also noteworthy that custodians can play a crucial role in marketing investment opportunities in Africa through effective linkages with other custodians in various markets as well as through global custodians. Their ability to adopt

international best practices will show the ease with which they can attract foreign portfolio investors (Marwa 2014).

2.4.0 Chapter Summary

The preceding literature review culminated in four themes standing out above the rest namely risk management, value-adding services, integration of systems and the regulatory framework. Various authors identified these four elements or themes as central in any discussion around custodial services in relation to portfolio investment inflows. It is evident from literature that the link between the role of custodian services and foreign portfolio investment inflows might be rooted in these four thematic areas. The discussion above highlights the existence of the different risk appetites among investors as well as the need to identify potential risks in custodial service industry and the role played by custodians to mitigate such risks. The issue value-adding services was also discussed by a number of authors cited above indicating that due to competition in the custodian industry, providers are broadening their service offering over and above the traditional custodial functions. The issue of system integration was also mentioned with examples being cited on how capital market growths have been impacted by promoting interoperability of systems and how this enhances efficiencies. Finally regulatory framework is another area of concern among investors as they seek legal protection for their investments abroad. The following chapter will focus on the methodology that was used to carry out the research.

CHAPTER 3

RESEARCH METHODOLOGY

3.0 Introduction

This research focuses on analysing the role of financial custodians in promoting foreign portfolio investment in Zimbabwe. This chapter hence focuses on detailing the research design and methodology used in gathering the relevant information required for analysis. It focuses on giving an account of the research method used, identifying the target population from which data was collected, how a sample was drawn out of the population, the data collection instrument used as well as ethical issues considered to ensure data credibility. The chapter looks firstly at the research approach, the designs of the research and goes on to discuss the data collection procedure and finally closures with a discussion on how the collected data is analysed, the research ethics considerations and finally the chapter summary. The detailed account on the steps taken is presented in the sections below.

3.1 Research Approach

Research work of any form is normally driven by the desire to categorise, describe, explain, evaluate, compare, correlate, predict and control among other things. These objectives are normally met through the use of two main approaches to research mainly, quantitative and qualitative research approaches or methodologies. The former is based on deductive reasoning whereby one starts from a general view of things which can be logically argued into a specific conclusion. The latter however is based on an inductive approach whereby one starts building a concept and conclusion out of observations and experiences a given phenomenon. The quantitative approach uses data which is measurable numerically hence is more objective in nature whereas the qualitative approach uses qualitative data which is rather descriptive in nature, mainly expressed in words and rather subjective since it cannot be measured in any one standard and universal way (Walliman, 2011). Qualitative research mainly focuses on understanding people's perceptions and how they interpret the world around them (Hox & Boeije 2005). Data for this approach takes the form of observations, interviews, historical records, and minutes of meetings as well as documentary films.

According to Walliman (2011) the subjectivity of qualitative research does not mean that it is inferior to a quantitative one and rather argues that its richness and intricacy helps in

explaining underlying facts about societies (Walliman 2011). Qualitative research also entails the derivation of meaning from words, concept building and the deriving of relationships among variables or themes which culminates in new idea generation as opposed to quantitative approach which is often guided by already established theories. For this reason this research will take a qualitative approach given its intention to explore the role of custodial services and possibly reveal underlying facts and keys that can unlock portfolio investment inflows in Zimbabwe. This approach will involve an in-depth analysis of the research phenomenon through in-depth interviews. Given the level of detail required to establish cause-effect relationships around the research subject a qualitative research approach is justified for conducting this study.

Carson et al., 2001 justifies the use of qualitative research because of its flexibility and suitability in tackling business related concepts and behaviour (Carson et al. 2001). The study acknowledges that very little research has been done on exploring the role played by custodians in Zimbabwe as this side of business is normally considered as a back-office function and often ignored hence the need to carry out in-depth interviews to enhance chances of capturing even the finest details from experts in the field. Given the focus on which the study places custodial services and portfolio investment, it is imperative to carry out in-depth interviews to understand how the custodial industry interacts with asset managers whose assets they manage on behalf of investors, both local and foreign as well as its interaction with stockbrokers who play the initial role in facilitating the sale and purchase of securities which ultimately end up the custodian “hands” and settlement banks which facilitate the settlement of traded securities .

3.2 Research Design

The research design looks at the model or specifications adopted as guidelines to answer the research questions. The choice of a research design is informed by the population chosen, the dependent and independent variable and how these are measured or quantified (Myers, Well & Lorch Jr 2010)

3.2.1 Study Population

A population is defined as a group of people with the required characteristics for a research from which a sample is selected (Singh 2007). The population of this research consists of

custodians, asset managers, stockbrokers and settlement banks. This population was selected to incorporate the key participants that interact with custodial service providers on a daily basis and also interface with the custodial services value chain at different levels. Zimbabwe currently has 7 licenced custodians, 15 asset managers, 13 stock broking firms and 2 settlement banks registered with Zimbabwe's Central Securities Depository, Chengetedzai (Pvt) Ltd.

The 7 custodians include Old Mutual, Standard Chartered Bank, ZB Bank, CBZ Bank, Steward Bank, Stanbic Bank and FBC Bank. These provide information regarding the custodial services provided and product diversity, their turnaround times, processes and control environment. Two of the custodians namely Standard Chartered Bank and Stanbic Bank are involved in regional and international custodial services which help in assessing the role played by global integration of security trading and the effect of global affiliations and linkages in the custodian business and investments in general. The population also includes 15 asset managers which are the companies entrusted by investors to manage their financial asset portfolios and make decisions in investing these assets to earn optimal returns. These companies are the vehicles through which huge investments can find their way into Zimbabwe namely in the form of mutual funds, pension funds as well as sovereign wealth funds in search of better returns. These firms are also required by law to have their assets placed with a licenced custodian in the interest of segregation of duties between management and custody. (Government of Zimbabwe 2010).

The population also includes 13 stockbrokers who play the role of security dealing. They are like the front line of the investment value chain whose role is to assess the demand and supply of securities in the securities market and matching buyers and sellers. Upon completing a deal, a stockbroker is also required by law to have the investor register with a custodian for the safekeeping and administration of the purchased securities. Stockbrokers in this research help in the assessment of the key aspects that draw foreign portfolio investors into choosing a particular custodian as well as perception that are held by these investors about the local operating environment. Finally the population includes 2 settlement banks which interact with custodians on a daily basis to facilitate settlements wherever securities held by a custodian are sold or bought. This helped in the assessment of the risks associated with the settlement process as well as enable as comparative analysis with international best practice and the role custodians play to enable an efficient settlement process.

3.2.2 Sampling

With the aim of gathering qualitative data from a population of 37 companies mentioned above, a purposive sample of 11 companies was selected through a convenience or judgmental sampling method from which respondents were chosen among managers in the selected asset managers, custodians, stockbrokers and settlement banks. Convenience sampling was used to minimise costs for data collection and also to target respondents that held managerial positions in the sampled companies. The study targeted managerial staff under the assumption that one's appointment to a managerial position has a positive direct relationship with one's length of service and hence accrued knowledge and experience in a particular field of work. One mitigating factor for recruiting respondents from one city namely Harare is the fact that all the sampled companies are headquartered in Harare since most of the functions are centralised in Harare mainly to enjoy close proximity to the central security depository (Chengetedzai Pvt Ltd) as well as the Zimbabwe Stock Exchange around which their business revolves.

Purposive sampling involves the selection of respondents based on their experience and knowledge of a particular subject (Bernard, 2002). Non-random sampling methods as these are often criticised for being susceptible to interviewee bias (Lopez, Atran, Coley, & Smith, 1997). However Tongco (2007) argues that purposive sampling can be useful in certain types for researches. Where a sample drawn purposively is representative of a given population then external validity is enhanced thereby making it possible to generalise results within a given context. When the data instrument used is correctly and efficiently administered, the findings become valid for that particular sample and decisions can thus be made on the basis of the findings relating to the sectors represented in the sample (Tongco, 2007).

The selected key informants were contacted via emails and telephones and personal visits in some cases prior to appointments being made seeking their consent. In order to ensure a meaningful discussion the interview guide was sent electronically 3 days in advance before the interview date to allow the interviewee to familiarise with the interview material and be able to confirm details of interest before the interview date. The participants were selected with the aim of getting a fair representation of the key participants in security trading, security management, security custodianship as well as security settlement to complete the portfolio investment chain so as to identify gaps in the operating environment, the risk management front as well as the effect of globalisation in cross-border trading.

According to Boyd (2001) in qualitative research a sample of between 2 and 10 participants are considered sufficient to reach saturation or a basis for making a theoretical assertion (Boyd 2001). Creswell (1998) recommends the same number with the exception that these should be “long interviews (Creswell 1998). The concept of theoretical saturation proposes that a research should continue to increase sample size until a point when the data collection tools is no longer adding new information. This means that an interview sample can be as small as 10, 20, 30 or even more participants (Goulding 2002). In view of this, anyone who attempts to ignore the saturation principle risks creating a flawed theory which could compromise the validity of research findings (Jones & Noble 2007). In view of the arguments in literature, the study involves a sample size of 20 interviews which gives a safety margin of 10 interviews compared to the recommended size of 10 participants by Boyd (2001) and Creswell (1998) which positively impacts the reliability of findings. Table 3.0 summarises the sampling structure and number of respondents.

Table 3.0 Respondents’ Selection

| Targeted Companies | Population | Sampled Companies | No. of Respondents |
|---------------------------|-------------------|--------------------------|---------------------------|
| Custodians | 7 | 5 | 10 |
| Asset Managers | 15 | 3 | 6 |
| Stockbrokers | 13 | 2 | 3 |
| Settlement Banks | 2 | 1 | 1 |
| Total | 37 | 11 | 20 |

Although random sampling is mostly preferred, it can be unreliable if there is low response rate, or there is missing data on the questionnaire due to lack of clarity of questions or subject complexity (Godambe 1982). Furthermore, where costs for collecting data are high due to dispersion of respondents’ location random sampling might not be feasible (Bernard 2002). Through the use of purposive sampling the researcher is better placed to probe interviewees to clarify responses as well as ensuring that the respondent fully understands the questions so that they do not answer what they think is being asked but rather get the opportunity to ask the interviewer for clarification and then provide more informed responses. The research therefore focuses of soliciting information from experts in the areas relating to risk management, value-adding services, integration of systems and the regulatory framework as they relate to the custodial service industry in Zimbabwe in view of information obtained from literature. The key informants approach is used to target those individuals that were well

experienced in the field under study and have acquired the relevant experience at various management levels in various organisations thereby making them better placed to provide insight into a phenomenon under research (Heide & Weiss 1995). Expert opinion was sought by way of in-depth interviews with the aid of an interview guide to keep the discussion focused and ensure that all areas of interest are fully explored, explained and answered as well as giving room for follow up questions on key areas of interest to capture new ideas.

3.3 Data Collection Procedure - Research Instrument

A combination of data collection tools were used namely audio recording of interview sessions and the use of an interview guide to avoid unnecessary digression from the subject as well as capture all verbal expressions to avoid loss of valuable insights during the interview. The interview guides had both open ended and structured questions administered to key informants in selected companies through in-depth interviews which lasted approximately 45 minutes. The open ended aspect of the interview guide gave room for probing all areas perceived to be unclear and where a respondent's input varied widely from the other respondents'. The guide was designed with sections that directly focused on the research questions to avoid digressing from the research objectives. Questions were asked to tackle the issues relating to services provided and their diversity, the control environment and efficiency of the system infrastructure. The other section sought to address the issue of risk management hence focus was on key risk types and risk areas as well as risk mitigating measures that are in place already in Zimbabwe as well as based on international best practice. The other section focused on the global picture, looking at the role of international linkages and affiliations and its effect on enhancing portfolio investment inflows.

The research also took note of the need to enhance of reliability and validity of the gathered data such that a similar study conducted in a different setting will come up with more or less the same finding. This was achieved by targeting professionals in the areas perceived to be relevant to the area of study. Given that most professionals subscribe to known professional governing bodies with uniform guidelines, the professions of the respondents were expected to have a bearing in their responses thereby making the responses or authentic and easy to interpret. At the same time the researcher was confident of obtaining high quality information in view of the experience acquired and positions held by the key informants in their organisations and field of operation.

It is common practise to use a contact person from a chosen organisation as its representative and deem his or her responses as representative of that particular organisation (Rossomme, 2003). Conant, Mokwa and Varadarajan (1990) described the use of key informants as an effective tool that does not significantly distort information about an organisation (Conant, Mokwa, & Varadarajan, 1990). Although this approach is time consuming and relatively expensive these shortcomings are outweighed by its ability to enhance response rate as well as improve accuracy of responses. In order to capture expert opinion the interview guide was targeted at managers at the line, middle and executive levels of the selected companies to foster data triangulation thereby enhancing response reliability given the different experiences associated with these levels in an organisation. The interviews were all audio recorded using a portable recording device and transcribed verbatim for easy analysis. In line with Poland's recommendations, points of emphasis were capitalised to easily capture themes (Poland 2002).

3.4 Data Analysis

The study used template analysis in analysing the data gathered from respondents. Template analysis involves analysing textual data to come up with conceptual themes which are then grouped in clusters to identify master themes of a given phenomenon (King 1998). The starting point of data analysis using template analysis is the creation of a coding template which summarises themes that are crucial to the phenomenon being studied obtained from the review of literature. The coding approach for template analysis is hierarchical starting with broad themes and then successively narrowing down to more specific themes. Once predefined themes (*a priori* themes) have been established the interview transcriptions are read with the aim of highlighting areas that are pertinent to the research questions. The predefined themes form the basis for coding related material found in the transcription and if new themes emerge, they are coded separately or used to modify or eliminate the predefined codes.

The codes generated in the first 5 transcripts form the initial template which is then used to code the rest on the transcriptions while in the process modifying it in view of other ideas from subsequent transcriptions. This exercise is an iterative process which comprises a series of coding and recoding to refine and modify the initial codes with new insights from the

interview data (Cassell & Symon 2004). At the end of the coding and them modification process the output is the final template which is then used for data interpretation and analysis. The research also augments the template approach by coupling it with a similar analytical tool called eyeballing which required repeated reading of interview transcript and encircling prominent phrases for coding to clearly isolate key ideas from respondents (Colgate & Norris 2001).

When using the template approach the researcher defines a codebook which is used for sorting and organising data for easy interpretation (Boyatzis 1998). Template analysis is often hailed for its flexibility to user requirement as opposed to other analysis methods namely the grounded theory which is too prescriptive (Cassell & Symon 2004). The two also indicated that the main disadvantage of template analysis is that it can result in voluminous text which can become too complicated for meaningful analysis. This shortcoming is however mitigated through the use of a relatively smaller sample made up of 20 respondents which is more manageable.

3.5 Research Ethics and Data Credibility

The issue of research ethics mainly rests in the need to protect the respondents from harm and unauthorised disclosure of information. The interview guide was accompanied by a brief introductory letter which clearly stipulates the intentions of the research. The right to privacy of the key informants was guaranteed by use of pseudonyms to identify the respondents for data processing. The research also sought interviewee's consent regarding audio recordings after assuring the participants of confidentiality and the purposes of the study via email notifications which is a crucial part of qualitative studies. To achieve this, the interviewee was advised to use a pseudonym to conceal identify.

The participants were also assured of the confidentiality of the interview information and permission to interview the participant was sought prior to the interview date with appointments being set and confirmed in advance. Effort was also put by the interviewer to ensure that interview duration was within agreed timeframes to avoid inconveniencing the respondents. In return for their participation the research assured the respondents that a copy of the research finding would be circulated to all participants as a form of feedback and also to clear suspicion on the use of the research findings and possible data manipulation.

3.6 Chapter Summary

The study was conducted using the qualitative approach hence the judgemental method was used to select respondents from asset management firms, custodial services firms, stockbrokers and from settlements banks. A sample of 11 companies out of 37 was selected with a target of 20 respondents to take part in a key informant in-depth interview. An interviewer-administered guide was used to obtain responses from the interviewees after which the audio-recorded interviews were transcribed and printed for data analysis. The template analysis method which makes use of a priori themes, codes and sub-themes was used to analyse data. The following chapter focuses on the presentation of the data collected using the approach and data collection instruments discussed above.

CHAPTER 4

DATA ANALYSIS, PRESENTATION AND INTERPRETATION

4.1 Introduction

This chapter presents, interprets and analyses the study evidence. All this is aimed at analysing how the role of custodians can be harnessed to make the service delivery channels more attractive, as well as examining its role in risk mitigation in securities trading to be able to capture new markets through global integration. It starts off with the descriptive analysis of the responses and explaining the data analysis procedure used. This is then followed by the presentation of research findings and analysis. The chapter then ends with a discussion and reflection on the research result in view of literature reviewed on the research subject as well as reflecting on the initial research proposition in view of the research findings.

4.2 Descriptive analysis

As indicated in the previous chapter, the aim of the study method was to have the scope that fully represented all the four players in the area of study namely, custodians, asset managers, stockbrokers and settlement banks. All the interviews were audio-recorded and transcribed verbatim for data analysis. Using the template analysis approach the transcribed interviews were subjected to hierarchical coding. Based on the template analysis approach broad *a priori* (predetermined) themes were used as the basis for constructing the initial template and these were derived from literature and constituted the main segments of the interview guide that was used, namely custodial service attractiveness, risk and risk mitigation and global integration.

A manual iterative process was then undertaken to formulate second dimension sub-themes and third dimension sub-themes using the new sub-themes observed in the first 5 interview transcripts which were coded and analysed at random. The themes obtained from the first 5 transcripts were used to further develop and expand the original template by including new coding new emerging themes until the process of coding had reached saturation with no new sub-themes and ideas emerging. Themes were developed through an iterative process of studying the pattern and contents of responds to a particular question across all the transcripts one at a time. In the process, all responses which supported a particular line of thing were grouped together to form a unique them or sub-theme with further analysis being done to compare the newly emerging themes and ideas to check whether it reinforces the original

themes from literature or it is a new discovery which can be used to explain the subject of study and the underlying relationships. These new themes and sub-themes were then used to formulate the final template (Appendix A).

All the remaining 10 interview transcripts were then analysed using the final template with some new themes and codes emerging and some being combined and still some being eliminated in the process. The coding process involved the use of highlighters of different colours to colour chunks of phrases and statements that corresponded to *a priori* themes as an initial phase. Then an iterative similar process was then done on the interview transcripts to further categorise the highlighted phrases and statements into various codes and sub-themes using concise headings that summarised the contents of the ideas that were coming out of the analysed data. The analysis started off with three *a priori* themes namely custodial services attractiveness, risk mitigation and global integration which finally increased to four themes as an additional theme, information asymmetry, emerged. Other second and third dimension sub-themes also emerged out of the iterative application of template analysis to modify the original template as summarised in Appendix A.

Below is a presentation and analysis of the collected data in seeking to establish the role of financial custodians (custodial service firms) in promoting foreign portfolio investment in Zimbabwe. The presentation below is grouped in line with the themes, codes and sub-themes that emerged from template analyses and also in view of the research questions below as highlighted in Chapter 1.

- i. How effective is the local custodial service delivery system in terms of service diversity, efficiency and attractiveness to foreign portfolio investors?
- ii. How does the custodial service industry help mitigate risk and enhance stock market attractiveness to foreign portfolio investors?
- iii. What role does global integration of custodians play in attracting foreign portfolio investors?
- iv. What can be done to improve their competitiveness and effectiveness in attracting portfolio investment?

4.3 Research findings

The following section focuses on the research findings in light of the main themes, codes and sub-themes as represented by the final template (Appendix A). The presentation links the

themes to their corresponding codes and sub-themes and provides the detailed explanations based on responses gathered through the in-depth interviews.

4.3.1 Custodial Service Attractiveness

This is the first theme from the *a priori* themes derived from literature review and it was further analysed and dissected into three second dimension sub-themes namely service diversity, service efficiency and service value chain which are discussed in detail in the sections that follow based on responses obtained from the in-depth interviews that were conducted.

4.3.1.1 Service Diversity

This sub-theme sought to measure variety in the service offerings within the custody industry as well as exploring the extent to which the local market has managed to respond to the new emerging business needs in view of the rise in capital flows in emerging markets investment portfolios (Gonzalez 2009). Below is a discussion on the sub-themes which explore the extent of service diversity in terms of service range and service reliability.

4.3.1.1.1 Service range

A list of common services offered by financial custodians was presented in the interview guide for confirmation. The responses confirmed that across all the custodians the role of safekeeping was core and all the custodians in Zimbabwe provide safekeeping services of securities for their clients. Formerly the service was given for safekeeping of physical certificates which were kept in vaults, however when securities were dematerialised this function is now being performed by custodian electronically in the clients' accounts held by the Central Securities Depository (CSD) system. Through these accounts they do record keeping by way of updating for sales and purchase of security. Respondent 5, from an asset management firm described custodians as *"the back office that makes things happen"*, to underscore how crucial the safe keeping role is to their operations. This service was described as core and fundamental in the sense that every investor needs assurance that his or her investment is safe and that there is something to show for it. They are interested in accuracy of recordkeeping and asset valuation models for example so as to be able to accurately measure performance of their investments. The dematerialisation of securities which started off in 2014 and the automation of trading were confirmed as key indicators pointing to

adoption of international best practice in this regard and speak positively about the potential of custodians in attracting portfolio investments to Zimbabwe.

The custodians also offer asset servicing which involves reporting on the assets held on behalf of investors and these can be shares or money market securities. With regard to reporting, all respondents confirmed that custodian send monthly reports to clients to give them a position regarding various information namely corporate actions and proxy voting and all these are usually stipulated with the frequency of standard reports being agreed through a service level agreement signed between the customer and the custodian. Corporate actions take the form of dividend declarations, interests, rights issues and share splits among other things. Respondent 2 from one of the custodian summed the role they place with regards to corporate action as follows, *“these need to be communicated and acted upon on time and it is our role to ensure that we track any related corporate notices which relate to the assets under our custody and take note of any deadlines within which action must be taken... We do follow-up to revenue collection and deposit the funds in our trust accounts on behalf of our clients...”* This role is crucial in keeping the investor abreast with what will be happening with his or her investment and decisions that need to be made within given timelines.

Emphasising how this role created the much needed link with the investors, respondent 7 from a custodian which is subsidiary to an international bank said, *“...In terms of exercising of voting rights we do proxies on behalf of our clients for example an investor in the UK might send an instruction to say represent me on the forthcoming AGM in this particular company. We then take that instruction and register a proxy form with the registrar and then come the AGM we go represent the investor on the particular issue raised.* This is how this service bridges the distance between Zimbabwe and an investor from any part of the world. However this is not enough as indicated by respondent 10, from a locally bound custodian, *“...in terms of the services offered in this market they are basically the same but the difference comes on other service delivery aspects such as the quick responses to the requests which the clients make”*. This means that the communication systems and even the tracking systems need to be world class if this service is to be provided competitively in a way that generates investor confidence. The other services that are provided include cash management through the use of bank reconciliations for the custodians’ trustee accounts to keep track of obligations, outstanding receipts and payments as well as identifying errors within an asset portfolio. Respondent (3) from an asset management firm also spoke of the unique roles played by custodians as *“the*

only neutral party... If it's in the money market they are responsible for the transfer of assets between the various funds." This is in relation to holding of security as collateral, for instance when they do a money market transaction they can get treasury bills or negotiable certificates of deposits (NCDs) as collateral so the custodian plays the "neutral role" in keeping the pledged security.

This is crucial in the sense that the ownership and benefits are not transferred during the tenor of the transaction and will only be transferred upon failure or when the security is called back by the asset manager. So the custodian gives all the confirmations required regarding such money market instruments as well the collateral that go with such deals. The neutrality provided by the custodian tends to engender confidence, trust and a high level of transparency which help in sprucing up the image of the country as a safe investment destination as well as minimise counterparty risks.

When it comes to tax administration all the respondents confirmed that custodians have no significant role in tax administration. All taxes are withheld at source by the transfer agent for example in the case of dividend payment. However in the event that the transfer agent for some reason fails to withhold the tax and the custodian notices that, they may withhold the tax because their systems are configured to withhold tax but these are exceptional cases. With regard to security lending, all the respondents confirmed that this is a relatively new concept in this market and not something that is prevalent in this market. The main reason for this was that the Zimbabwean securities market is not yet liquid and deep enough to cover the risks associated with such hybrid services and there are also no legal provisions allowing security lending locally.

One respondent (9) from a stockbroking firm concluded by saying that Zimbabwe is only scrapping the surface because dealing is merely restricted to pure equities mostly and there are no hybrid products being traded namely derivatives. He also indicated that it is only recently that Zimbabwe is beginning to develop a bond market. He also indicated that a lot still needs to be done to expand the range of services on offer saying "*....so we are really a very small player even looking at the volumes of trades that go through daily.*" A narrow product range tends to deprive the market as well as investors access to the various risk mitigating instruments such as derivatives as well as security lending which help investors in hedging their investment positions as well as earning additional income in the form of fees on

security lending thereby boosting investment returns. The narrow range of security instruments in the market is putting a constrain on the service range provided by custodians

4.3.1.1.2 Service / Product Suitability

Firstly in order to allay fears which investors might have regarding liquidity, processes and financial stability all the custodians are in one way or another linked to a bank or a big financial institution, the study has revealed. One respondent (8) from one of the settlement banks added, “...*These are most important as far as adding to market integrity and reducing risk. You find custodians are usually backed by banks with big Balance sheets.* It is in the interest of the investor that custodians get aligned to well-regulated institutions such as banks given the rigorous supervision that is subjected to most banks. However the current liquidity crises which led to the closure of a handful of banks in Zimbabwe sent a negative message to the investors’ community. However the reason why custodians still have potential to turnaround the situation is as one stockbroker (2) said, “... *you know there are investors that are long-term in nature that do not really change their portfolios.* While it is important to retain those already at hand, it is crucial to continuously make custodial services more client-specific and responsive to investor needs.

Another selling point is on the reporting function whereby reports are tailor-made to be comprehensive enough, giving all the information to the client, simple or complex enough to match their intellectual capabilities and objectives. All the respondents also confirmed that custodians also collect revenue namely the dividends and interest income on behalf of the client and do reconciliations on any income that is expected to be received by their client. The study also revealed that the custodial fees charging models are all tilted in favour of portfolio size as affirmed by responded 6 who said, “...*so the higher the portfolio value the less the percentage charge.*” These percentages are all negotiated on a per contract basis and in light of the affluence of a given investor as well as with the aim to undercut competitor prices. When carefully applied the Zimbabwean custodians can take advantage of the cost benefits of the ongoing systems automation and make use of penetration pricing model which thrives on attracting volumes through offering the lowest custodial fees with a long term goal of achieving greater economies of scale.

In Zimbabwe the dematerialisation process was not made to be compulsory hence there are securities that are still in physical form so it is the role of custodians to ensure safety of such. In that respect, access to the vaults where these securities are kept are strictly controlled to track their movements and values as well as reconciling the related asset portfolios. In view of the prevailing economic environment, the securities market authorities have delayed the introduction of high risk and complex financial instruments namely derivatives. Respondent 3, an asset manager concurred with the authorities' sentiments saying "*...It's a noble move but because of the risks involved in our market, and looking at the fact that our market is a bit shallow*" This then implies that the custodial services provided will simple mirror the product offering in the securities market.

4.3.1.2 Service Efficiency

This sub-theme was designed to assess the efficiency of custodial services delivery channels in terms of turnover rate or turnaround time, the processes and procedures that are in place, and the extent to which investors' interests are protected, which falls under the third dimension sub-theme. These third dimension sub-themes discussed in light of the responses obtained from the interviews in the sections that follow.

4.3.1.2.1 Turnover rate

The efficiency of securities trading cycles is generally measured in terms of the turnaround time with code T+2 for example meaning trading day plus two working days. Before the advent of the central securities depository (CSD) and the securities trading automation the trading cycle was T+7 which has come down to T+5 after the automation with plans to reduce it further down to T+3 though current infrastructure is not yet capable of supporting this. What it means is that if one exceeds the T+5 threshold then that trade is deemed to have failed to settle. Explaining further on failed settlements, stockbroker – respondent 2 highlighted that once settlement fails trade, "*...it is not reversed but chances are that you will risk an interest claim from the counterparty who was supposed to have received the cash*".

It is also important to note that at the centre of the settlement process is the custodian who ensures that its settlement account held by the settlement banks is well-funded to meet all obligations to settle securities purchased by its clients. Respond 9 another stockbroker emphasised this saying, "*...successful settlement and security of their assets is the investor's*

prime concern... what he wants to hear from me is “Deal Settled” not, “Ahhh we still haven’t received the shares and we don’t know what’s happening”. The other issue revealed by the study is that this market currently does not allow for turnaround trading, meaning that if you trade you are not allowed to immediately change positions if price have turned against you or in your favour. One example given by respondent 9 was that if for example you buy shares today and the next minute the share price turns out in your favour, you are not allowed to sell the shares, you have to wait for the settlement date and then sell after the 5th day.

Turnaround trading is allowed in other markets though it has a tendency of promoting speculative behaviour and is usually allowed in markets where there are other risk hedging financial instruments namely derivatives. Custodians normally distinguish themselves by the service delivery aspects, for example, foreign clients usually give instructions requesting for cash and you would need to transmit this as fast as you can outside the country bearing in mind that the client could have gotten an opportunity in another market. The degree of promptness and accuracy in executing instruction will also determine a custodian’s ability to retain clients as well as increase its asset base. Other developed markets are already trading at T+2 hence the need to further streamline processes in the Zimbabwean market to reduce the turnaround time to competitive level or the country will risk being shun by portfolio investors.

4.3.1.2.2 Processes and Procedures

The introduction of the CSD came with new processes and procedures which again elevates the role of the custodian in the securities trading process. The study reveals that processes and procedures are crucial in putting in place the much needed checks and balances and segregation of duties and responsibilities to curb possible frauds and collusions. The custodians do not just keep financial assets or securities but whenever an investor wants to make an investment, the custodian model which was recently adopted required him of her to open an investor account with a custodian on the CSD system. The custodian is also responsible for opening a bank account for that particular investor which is used for receipts and payments of all security trading related funds. Respondent 11, a custodian summarises the process saying, “...we keep the money in a trust account and notify the asset manager for further instructions....the trust account acts as transitional account for all payments and receipts relating to securities. There are authorised signatories to these accounts and cash /bank reconciliations are done regularly for the trust account.”

The securities market now has a lot of controls and stop gap measures that mitigate to a greater extent any attempts to commit a fraud because for example, both the asset managers and stockbrokers confirmed that there are no longer allowed to handle cash meant for investment as this is now the preserve of the custodian while the role of the former is now confined purely to management of asset portfolios and stockbroking respectively. In confirmation one asset manager, respondent 3, said, “...so we might have four or five bank accounts that are with custodians so that takes away a lot of risks that might cause fraud.” This places the custodian at the centre of all controls and its contribution becomes very relevant to an investor’s investment decision.

The trust accounts are also managed in a systematic manner which ensures segregation of duties. If the investor is a foreigner he / she either appoints an agent or an asset manager from whom the custodian receives instructions regarding buying or selling of securities. At the same time the custodian in consultation with the investor assigns independent signatories who will authorise the movement of funds in client accounts for payments. The custodian also assigns a finance person to be responsible for all the accounts such that when an investor deposits funds to buy shares for example, the asset manager might know about the deposit through a bank statement of the investor’s account but the custodian also awaits investor’s (or appointed agent) instruction before they can execute the asset manager’s instruction. When all confirmations have been done respondent 3 confirmed, “....what we then do is that if we want to invest in shares, we send instructions to the custodian that we have bought shares so can you please pay so and so....” These processes go a long way in boosting investor confidence when done efficiently and accurately.

The custodian goes on to settle on behalf of the investor and ensures that the correct type and quantity of shares reflect in the client’s CSD accounts. All the custodians that were interviewed confirmed that they have their own internal system which they keep as a mirror reflection of the CSD accounts in order to reconcile the two positions. This is also a check against any fraud that might emanate from the CSD. These internal systems are tailor made to meet the reporting requirements of investors and have tracking and flagging systems that are useful in recording important events namely corporate actions. In the case of clients under an asset manager, the custodian might also be given a list of authorised counterparties where they would say if an asset manager tries to deal with anyone who is not part of those

counterparties then the custodian would not pay for that investment without notifying the client. This arrangement is normally put in place especially for those clients that insist on the issue of counterparties as well as for issues to do with compliance.

Errors in trading are mitigated by the role of the custodian in deal confirmations and verification with the broker and the asset managers. Whenever a sale or purchase of security happens the custodian received a deal note from the broker who facilitates the buy or sale and then checks against instructions from the asset manager or client before the security can be registered in a different name and it is the custodian that can either accept or reject a deal note. Errors in trading can also be identified through reconciliations prepared by the custodians to reconcile what they have against what the asset manager has and where there are any discrepancies the two exchange information to clear them.

When asked about the most important factors stockbrokers would look at when considering which custodian to recommend to an investor seeking to register with a custodian respondent 2, a stockbroker said, “...*that would be how efficiently does the custodian handle settlements, ... do they settle on time or do they have settlement issues?*” In view of the sensitivity of the settlement a process was put in place whereby when trading is done they automatically go and hit the particular selling client’s account up until the settlement date. So at the end of each day they send pre-settlement reports to the parties involved in the trade which shows the trades that were done on that particular day as well as the value of the trade and who the buyer is for confirmation as to check whether the trades on that report are genuine. This is done by checking with the broker notes from the broker and the deal notes from the client. This process helps in eliminating errors that could have emanated from the broker in the trading process. If there are any changes that need to be done then CSD staff is notified as well as the stockbroker so that adjustments can be made. This process is crucial in view of the penalties and delays that are associated with a failed trade.

In addition custodians also conduct what are called scrip (share certificates) counts and this is done before a reconciliation where they are actually tracking physical stock of the investor’s asset to establish whether they agree to what is held by the asset manager (this applies only to securities still in physical form). The segregation of duties between the stockbrokers, asset managers and custodian brings in the independence which would lure most investors. When asked what controls have been put in place to curb management fees computational errors

respondent 1 from a custodian firm said, *...the controls are engrained within the setup...since our custodian fees are driven by the asset portfolio size it is in our best interest that this number is closely monitored and validated... that's where our profit comes from...* Any efforts meant to enhance accuracy in this regard will also be meeting the investor's interests alongside. All the custodian interviewees confirmed that the custodian business is a technology driven business citing the fact that the required controls are so numerous such that technology driven processes are not efficient and cost effective than human labour. However the study also reveals that in terms of investment in state of the art custody software, custodians that operate under international banks are well ahead of those aligned to local banks owing to differences in financial "muscle" as well as technology sharing.

4.3.1.2.3 Investor Protection and liability

The regulator realised that some of the asset managers and stockbrokers were abusing the securities that they were holding on behalf of their clients so legislation was put in place to segregate the duties of asset managers as well as stock brokers. This made it mandatory for them to appoint a registered custodian so that the custodian is the one that keeps all the securities on behalf of clients. Since all investors do invest to earn a return, it is of interest to them to ensure that all liability or losses generated from custodian's fault are all borne by the custodian. The interview guide also included cases covering a number of scenarios when an investor can possibly be prejudiced by a custodian and responses were sought to establish whether or not the custodian would be held liable.

The overall consensus was that a custodian will always be held liable whenever their conduct violates any sections of the service level agreement between the client and the custodian. These may include among other factors, failure to collect dividend and interest income, failure to act on corporate actions, delivering securities before payment and overcharging of custody fees. Custodians who fail to fund their settlement accounts or fail to collect revenue on time face the risk of facing interest claims from affected beneficiaries. The asset managers normally have their own service level agreement separate from that of the custodians while stockbrokers can also have their own service level agreements with foreign broker partners. Respondent 1, from a custodian firm gave an illustration of what would happen if they miss and do not exercise rights option for a client in error saying, *"...In some case you may have to pay the extra cost say for example if the rights issue provided that the client could pay*

\$0.10 per share but the same share is going for \$0.15 then the custodian will have to foot the 5cent difference to ensure that the investor is able to buy the same amount of share he was entitled in the rights issue....”It is important therefore to ensure that all possible eventualities are fully covered by a service level agreement at the onset to avoid unnecessary conflict.

A question was posed to one of the interviewee stockbrokers on other protective arrangements which are currently being enjoyed by the investors as well as any future plans given their role on the front line of the investment value chain. The response was that currently there is an investor protection levy, and there are plans to set market rules for broker guarantee fund as well as settlement limits for brokers. The investor protection levy operates by way of raising a levy on every trade that is executed and this goes to an investor protection fund. In the event that an investor is prejudiced somehow by the market or by his broker he / she can apply to have a reimbursement from the investor protection fund. In addition whenever an investor is not satisfied by the way a transaction is handled he / she has the right to seek redress firstly through the Zimbabwe Stock Exchange (ZSE) and then through the Securities Exchange Commission (SEC).

4.3.1.3 Service Value Chain

This sub-theme is meant to analyse the value chain of the custodial services delivery channels in order to assess value contribution at various points along the value chain. It is further split into two third dimension sub-themes which are value chain participants and service synergies which are discussed below.

4.3.1.3.1 Value Chain Participants

One of the key investment value chain participants is the asset manager and the most important aspect of an asset manager’s work is management of asset portfolios. Asset managers interact with the custodian quite often to using their investment expertise to invest funds on behalf of their clients. So an asset manager harnesses funds from various clients and pool them into a huge fund so as to be able to negotiate better returns. At the same time they do precise allocation of capital in terms of seeking the best returns. Their activities interface with that of the custodians through providing the largest asset portfolios for custody services. These linkages have created opportunities for mergers and acquisitions of custodians and asset managers. Asset managers from abroad also tend to deal directly with local custodians

without the need to go via local asset managers with the aim of avoiding asset management fees given that they are in the same business and are bringing assets from abroad that are under their management.

Stockbrokers are also an important player in the value chain who takes the “front seat” in the value chain. Describing their role as stockbrokers, respondent 9, said, “.....*we go out and hunt....you approach potential clients, potential broker partners...*” Stockbrokers tap into foreign markets through foreign broker partnerships based on commission sharing agreements, which help create long term relationship which also creates access to new potential clients. What normally separates brokers in a market is their ability to develop relationships, the quality of their research and how regular they send out their research work to potential investors.

4.3.1.3.2 Service Synergies

The service offered by custodians and asset managers tend to be complementary creating potential to generate a competitive advantage through this seamless connection to enhance service delivery. The custodian also facilitates security settlement, such that when an investor wants to sale his / her security for example, he/she approaches his/her asset manager who in turn engages a stockbroker. The stockbroker then looks for a buyer who wants the share via the ZSE and when he finds the buyer and they agree on a deal price, this in turn is communicated to the asset manager who then instructs the custodian about the sale. The stockbroker also sends a deal note such that before transfer of the asset the custodian has to first confirm and compare instructions from both the stockbroker and the asset manager. If these agree and the corresponding value for the share is deposited into the custodian’s trust account only then can the security be delivered to the buyer and proceeds are transmitted to the seller as instructed by the asset manager. The same process happens when a purchase is made and at the end of the day the custodian has to update the investor’s account accordingly. One of the respondents described this seamless interaction with much clarity saying, “....*With custodians we touch on several things but you are sure to find that the custodial services are more or less the back-end of the asset management business and they are mainly responsible for the execution of transactions...*” Related to this, if there is need to sell assets from one client to another it has to go through a stockbroker to show that this is not an off-market transaction or a situation where you are trying to defraud someone in terms of changing

stocks even if the clients share the same custodian. There is however need to engender a culture of discipline in the market as there was a tendency among some investors of selling securities which they did not have thereby creating counterparty issues with stockbrokers. This in a way is expected to be addressed by the securities trading automation.

The asset managers interviewed all confirmed that they have clients who come directly to them and some of these clients, (Respondent 3) “... *giving you money is all that they know, so they are not really worried about who is going to manage their bank accounts and where are the shares going to be held.*” In such cases the asset manager is given the discretion to choose a custodian for their client. This can create a perfect opportunity of a business synergy between the asset manager and the custodian whereby they can enter profit sharing or fee sharing arrangement so as to lower their combined cost to foreign clients which would ultimately make their services more attractive to foreign clients. The same arrangement can also be done for foreign clients that come through foreign broker partnerships.

Custodians can also go and market their services rather than wait for business from asset managers and stockbrokers. It is very possible and easier for a foreign investor to send money directly to a custodian then engage a stockbroker to buy specific securities with the settlements being drawn down from the funds held by the custodian in trust. So when the investor wants to disinvest he/she instructs a broker again and the proceeds are transferred to the account held by the custodian for onward transmission to the foreign investor by the custodian. It is however important for the market to embrace a spirit of good workmanship and ethics to promote synergies. One of the broker interviewees (respondent 2) aired out a complaint relating to the lack of teamwork and cooperation by some custodians saying, “...*there is a tendency sometimes when custodians dump it on the broker’s lap to handle and fix issues on his own yet both the broker and the custodian are serving the same client...*” The stockbroker’s argument is valid given that the broker only gets a once off brokerage fee currently packed at 0.92% per trade value whereas the custodian will get long term streams of income meaning that the custodian is supposed to go the extra mile in trying to resolve queries that might turn away or inconvenience a client.

4.3.2 Risk and Risk Mitigation

Risk and risk mitigation is the second theme adopted onto the initial template as *a priori* theme from literature review. It was then sub divided to further assess the role contributed by

custodial services in identifying risk exposures and putting risk controls in place and these third dimension sub-themes are discussed below in details based on information collected from the interviewees.

4.3.2.1 Risk Exposure

This sub-theme looks at the risk exposure in terms of the risks that are embedded in the agency problem within the investment circles as well as the risk dimensions in the custodial services business and these third dimension sub-themes are discussed below in detail.

4.3.2.1.1 Risk and the Agency problem

The agency problem, that is, the tendency of having mistrust and conflicting interest between the agent and the principal was quite immense during the stockbroker model era that is before adoption of the custodian model in Zimbabwe. To confirm some of the fears which the principal (the investor) has, respondent 7 from a custodian firm indicated that “...*in terms of assets that are held, the client need to know the segregation between the assets that are owned by the particular custodian which they are holding on their own behalf and the assets that they are holding on behalf of that particular client so there has to be a line between those two....*”. Before the custodian model was adopted the broker would receive money directly into his bank account from an investor and he could misdirect those funds and the broker could also keep the client’s shares in his office.

A stockbroker could study his client’s trading patterns and pick on those with very long term and inactive portfolios and the broker could sell those shares without the client’s knowledge and possibly buy them back after making a profit. So the fraud was being facilitated by the fact that the broker could hold both the shares and the money at the same time which created a direct conflict of interest. Respondent 1 from a custodian firm also added saying, ...“*So in times where certain stocks perform better than other stocks you will find that the stockbrokers would take part of those stocks tagging them as his own and swapping those that are not doing very well to appear as part of the clients’ portfolios so that was the major problem because really you couldn’t tell....*” This kind of malpractice betrayed investor confidence in the local market. However the principles that govern the custodian model are meant to eliminate all the weaknesses on the broker model thereby giving Zimbabwe a chance to draw back the investors lost to other markets.

Already in the Zimbabwean market and other markets there is debate around the consent of self-custody. This entails a situation where an asset management firm also creates a subsidiary which offers custodial services for both the asset manager as well as the external clients. During interviews the five asset managers were asked to discuss their position on this issue. Three schools of thought emerged from the discussions. The first one is the view that self-custody normally compromises the independence that should exist between the asset manager and the custodian and it might also increase fears on possibility of collusion and misappropriation of funds hence this arrangement tends to upset the whole essence of segregation of duties. The second view was that self-custody is proper because even if they belong to the same group these companies operate as separate subsidiaries and separate legal entities with their own board of directors and under the supervision of SEC. The last view is that as long as that information is fully disclosed to the clients, it is for them to choose and some clients prefer the arrangement as they would be putting their confidence in the strength of the whole group or the brand name.

The asset manager interviewees also indicated that this risk around the agency problem is being managed through service level agreements as well as the investment mandate and guidelines document which becomes the basis of any form of investments done by the asset managers. So the service level agreement will stipulate the signatories to the investment account and if the fund is run by a board of trustees then they would make a resolution to appoint the signatories to that account so whatever instruction that they give is what the custodian takes. Others are making use of a trustee account as revealed by respondent 3, saying, “...in our case the asset manager’s investments bank account is managed by the custodian and it in essence acts as a trustee account.” The asset manager is also bound by the law for any fraudulent activities perpetrated by its staff for example the use of client funds to cover own loss position would amount to gross misconduct and the asset manager is liable for such misconduct and could risk losing his / her licence as well.

4.3.2.1.2 Risk dimensions in custodial services

In this section questions were asked to establish the common risk types that affect the custody business as well as assess the current measures that are in place to mitigate such risks. The interviews reveal that the seamless connection and interactions between the custody business, the asset manager and the stockbroker makes the industry susceptible to all forms of risks that affect the stock market namely business systems, the country risk, political risk, counterparty

risk, liquidity risk, settlement risk, operational risk, security theft and risk of terrorism financing. Some of the mitigation measures are discussed below.

As a measure to mitigate terrorist financing proper “know your client” (KYC) documents are requested and verified to really know the identity of who is investing. If the investor is a company there is need to know who the directors are and there is need for a separation between the directors and the shareholders in terms of running that company as well as giving instructions for trade. Other operational risks are catered for by way of setting up disaster recovery sites which act as an alternative cite in the case of a disaster namely system failures, floods and power failure among others so as to ensure business continuity and mitigate the chances of market-wide system failure. The interviews also revealed that if a custodian is failing to connect to the CSD, there are some off site offices where one can go and connect easily.

The automated trading platform is expected to reduce both transaction costs as well as the turnaround time which tends to minimise settlement delays. The electronic form in which most security is now trading in also reduces the risk of security theft. Staff training and refresh courses are also being used to try and reduce the number of trading and capturing errors over and above the traditional emphasis on adherence to processes and procedures.

4.3.2.2 Risk Controls

This sub-theme was adopted to explore the different option and angles from which controls can be enforced in the custody business namely legislative controls, technology driven controls and structure driven controls which constitute third dimension sub-themes which are discussed below in greater detail.

4.3.2.2 .1 Legislative Controls

These are controls that are put in place by the enactment of a law to restore sanity. The interviews indicated that legal controls have gone a long way in changing the way of doing things in the custodian business and securities trading. Prior to the adoption of the custodian model the market was broker dominated and what would happen is that a stockbroker would keep a nominee account in which he would keep all the assets so they were not in a specific account linked to a particular client so they would just keep all the stocks in one account

making it very difficult to identify which stocks belong to which client. However the new regulation requires that all investors should open a CSD account with a registered custodian and no one is allowed to trade without a CSD account number. The same rules also apply to foreign institutions or individuals seeking to buy shares in Zimbabwe; they would need a settlement agent in this case a custodian.

One of the custodian interviewees, respondent 13, raised the issue of standardising the modes of communication in the custodian industry through legislation. In view of this he said “.... *Personally I think there are certain minimum requirements that need to be enforced for all custodians to operate competitively namely the requirement to use standard platforms like SWIFT....*” This is because foreign investors need regular updates about their investments and platforms like SWIFT will put the local custodians at the same footing with other competitors in the region. The advantage of using the SWIFT platform is that it has the ability to encrypt communications to and from the foreign investor and that way the investor’s need for confidentiality is safeguarded. The down time of SWIFT is almost nil given that it is used world-wide which would also promote effective communication.

Regulatory controls that are enforced through the regulator also give investors the comfort and assurance needed. The asset manager interviewees all confirmed that their regulator, SEC has the power to revoke as asset manager for misappropriation of clients funds for example. The same respondents also indicated they will be held liable if they use client fund for their own operations, or even engage in activities that go beyond their investment mandate and client guidelines. Speaking of negligent conduct respondent 3 (asset manager) explained saying “... *we will also make good of any losses incurred out of negligence on our part, for instances there is evidence that there was no sign of any meaningful investment that was done on funds deposited with you 10 years resulting in losses that were avoidable.* These punitive measures do go a long way in ensuring professionalism and promoting high ethical standards.

When asked about any other risk mitigations measures that have been adopted in other markets the stock broker suggested the legal enforcement of guarantee funds and settlement limits. So what would happen for the brokers is that they would be required to contribute to a broker guarantee fund which basically would take up settlement in the event of the broker failing to do so. The guarantee fund would take up the deal and settle with the counterparty then the broker would have to pay back into the guarantee fund. The settlement limits would

also be another layer of protection and what happens with these limits is that the regulator would assess the broker's trading pattern history and determine a settlement limit for that particular broker. This will restrict a broker from taking more than he can bear. This would go a long way in mitigating settlement and counterparty risk thereby ensuring market stability.

4.3.2.2 .2 Technology Driven Controls

This section analyses the role played by technology driven controls in mitigating risk in the custodial services sector based on the responses obtained from the interviews conducted. The key aspect that came out is the fact that technology or information systems driven controls form the basis of any meaningful development in the custody business. Controls that are enforced through computerised processes have the advantage that they are designed out of a wealth base of experience, business requirements, thorough analysis and testing and most of the systems that are used are usually tried and tested systems thereby guaranteeing their reliability. The adoption of system driven controls helps in minimising human input and hence human error. These systems also leave an audit trail which can be used to track anomalies in the process. Respondent 9 emphasised this by saying, “.....*automation is a game changer and should see our settlement cycle coming down say to T+3 and it should also bring the overall transaction costs down*”.

The automation of securities trading has already ushered a new era in the securities market in Zimbabwe. The respondents revealed that before the CSD was launched there were incidents where due to human error the transfer secretaries would miss banking details for first time investors and when dividends were declared these investors would have challenges in trying to access their dividends. The other respondent puts it as follows, “...*cheques were mailed to the beneficiaries but some never received them.*” Such incidences have the effect of turning away investors and deplete investor confidence in the local systems and controls. However in the custodian model each and every client has his or her securities registered in their own name including their banking details with their asset properly segregated such that dividends are sent automatically to the beneficiary without any issues.

Coming from a background of a manual open cry system to a fully automated trading system is a huge leap forward in enhancing processing efficiency. All the respondents agreed to the fact that when an electronic trading system is in place, all the transactions done at the ZSE

filter directly to the CSD so that if a broker transacts on behalf of the client, the transaction will update the client's account automatically. Also when shares are sold, they are moved from the available shares list into a pool where they are kept until they are settled. Therefore when the settlement date arrives the money is automatically transferred from the account of the buyer to the account of the seller and the shares are also transferred accordingly. Therefore the settlement process involves the movement of money to the seller and the movement of shares to the buyer in the CSD.

One area that still needs to be looked at is with regards to the matching of trade. This is a critical part of the settlement process which if automated transforms the whole processes to world class standards which would greatly appeal to the foreign investors. It involves a process whereby upon receiving an instruction from the investor and a note from the broker the custodian must match the two and check if the investor has got the securities. The only issue that need to be further explored is the way in which the deal confirmation rules operate and the implications it has on the market participants. This process ensures that at T+1 by 2pm the custodian is expected to confirm that the trade will be able to settle. However if the custodian fails to confirm within the required timelines for any reason then the system automatically forces the deal to go through thereby forcing the custodian to accept the position and if the investor has no securities to sell, then the custodian has to look for those securities in the market to fulfil the deal. The process whereby unconfirmed deals are automatically forced through can create serious problems. This is because there could be genuine reasons for not confirming and automated approval tends to bypass the independent checking process for accuracy and fraudulent activities.

The other technology gap that needs attention is the inability of the custodian's system to interrogate the CSD system. One custodian interviewee indicated that custodians often run the risk of getting management fees computational errors due to this communication gap. Basically the custodial fees are a function of the portfolio size and if the portfolio is not up to date then the fees computations are bound to be wrong as well. If the two systems could be linked then this would eliminate the need to manually update the custodian's internal systems. Respondent 1, a custodian explained this saying, "*...for instance if a client sells a security and we fail to update the portfolio then we will end up overcharging that client and the same applies if the client buys a security and we don't update the portfolio... we end up undercharging that client.*" These instances are more prevalent with money market

instruments where they mature and are not redeemed from the portfolio. This then means that the custodian may continue to charge a client of a position that has already matured and if the client has been paying attention to detail he may query the charge and claim interest on the overcharge. There is need for an effective system driven mechanism for flagging the systems to take note of such maturities and other important events so as to minimise errors and penalties.

The impetus on curbing worldwide facilitation of terrorism and anti-money laundering can also be addressed through technology driven controls. One respondent from a custodian that is linked to a global custodian indicated that they have a system which screens the clients that they deal with to check whether they are internationally blacklisted or on sanction list. When probed how the system operates he said, “...*for example our system will screen out any clients from North Korea, Sudan or Burma... so there is a database which assist in the screening process of that nature and all daily trades under the same screening.*” Therefore the ability of a custodian to implement systems that have such screening mechanisms will send a positive message to the international market of investors. Although such screening tools might be applauded to by the nations that initiated the blacklisting, there is a risk that the country might end up losing genuine investors from the blacklisted countries.

4.3.2.2.3 Structure Driven Control

This section discusses the responses that relate to controls that work as a result of the way processes and functions are structured. The main concept that was highlighted by all respondents is around the segregation of duties. This means that any process that is followed must not start and end in the same section or department or organisation depending on its size and nature. This is mainly to curb collusion and provide an independent check and verification from someone who is detached from the origination of a transaction. This setup is the core principle of the custodian model which Zimbabwe adopted.

The custodian model ensures that there is a rectangular set up to complete the process with the custodian, the asset manager, the stockbroker and the settlement bank. This means that a custodian would not release funding without a deal for instance. This makes the custodian the gatekeeper thereby ensuring that the funding is honoured at least upon evidence that it is going towards a confirmed deal and anything outside of that would not receive funding from the custodian. Instances where asset managers would misappropriate funds usually happen

because the asset manager would also be doubling as a custodian. The solution to this is the principle of segregation of duties and this is what the Zimbabwean market has adopted sending a positive message to the world of investors.

The risk that has to do with delayed settlements and errors is one that can be self-correcting if local custodians begin to be outward-looking as opposed to being inward-looking. The responses obtained revealed that this issue is the reason for the T+5 turnaround which is often missed by some players. If local custodians begin to look outside in search of new business and affiliations with global custodian they will begin to be introspective and seek to improve their process in order to attract partnerships and new clients. The main problem with the custodian model as revealed by one of the interviewed stockbroker is the fact that the adoption of this model has to a great extent brought complacency within the custodian business in terms of searching for new business. The stockbroker, respondent 9 explained further saying “...*This follows partly because the law has set them up already to get clients on a silver platter from asset managers and stockbrokers*”. How this works is that as the custodian strives to create a good track record in the market as well as averting possible interest claims for late settlements the custodian is pressured to ensure that it has a robust control environment, systems and procedures that keep errors and delays at minimum possible levels.

In the interest of promoting transparency the market has by default created two triangular structures, first between custodian, asset manager and the client and secondly between the custodian, the stockbroker and the client. The source of any deposits is verified and any instructions to transfer funds is reported and verified with the client to ensure that the client is also in the picture of everything that happens. For instance the asset manager would have their own bank account that is controlled by a custodian and ideally if a client sends money it goes to that bank account which the custodian has an oversight over. The other scenario is where a client might give an instruction to both the asset manager and the custodian to say all his / her funds should be invested in the money market and if per adventure the asset manager starts investing that money in equities the custodian knows because they are the ones holding the bank account and receives a deal note from the asset manager to transfer funds so since the custodian also knows the investment mandate they have the right to query or even reject that instruction.

Another respondent talking about the structures that are now in place indicated that, “...*This gives an extra protection to the client in that yes, I have control in terms of how the funds are used but there is someone controlling the movement of those funds and even records what the funds were used for and ensure that they have received what was bought by that money.* These triangular structures are quite deterrent because even if an asset manager were to falsify that they are the owners of certain shares that claim would not hold as there has to be a record on the inflows and outflows pertaining to the sale and purchase of those shares. This is because there is a custodian at the other end checking what the asset manager does to help in curbing frauds.

4.3.3 Global Integration

The aspect of global integration forms the third main theme that was adopted from literature as *a priori* themes. This aspect seeks to establish the role played by global custodians and how they can assist custodians in gaining access to the foreign market with the aim of reaching out to other markets to get in touch with new potential investors.

4.3.3.1 Global Custody

The above sub-theme was developed to assess the role of global custodians in providing access to international markets and is subdivided into two third dimension sub-themes namely global footprint and global affiliation and confidence which are discussed below.

4.3.3.1.1 Global Footprint

The effect of globalisation has turned the world into a “global village” and one’s ability to penetrate and easily gain access to other markets automatically places a company on a higher footing. The custodial service business is a business which thrives on volumes due to the lower margins imposed by competition. The fact that the fees are not regulated and based on negotiations leaves the players to compete based on their pricing strategy. Therefore access to other markets will increase transaction volumes and therefore economies of scale. Striving to gain market share in the international market is so crucial in that if for instance a custodian is solely based in the local market which has clients that are interested in another market, the chances of losing these clients to competitors with foreign market linkages. The respondents also revealed that the Zimbabwean market is dominated by single market custodians with only two that are subsidiary to global custodians. This means that Zimbabwe as a market is not well represented in the international market.

One respondent 10 from a settlement bank said, “...*These global custodians are really the conduits for foreign portfolio flows.*” The respondent added that this is mainly because custodians do not set up shop where there is no vibrant capital market because most of their business is generated from capital markets. It follows that when global custodians enter your markets then it speaks positively about your market in terms of the activities that are happening and wherever they go investors are bound to follow them. The respondents also indicated that the standardisation of regulation across different markets can also assist in putting the country at the same footing with other global players.

4.3.3.1.2 Global Affiliations and Confidence

Based on the data collected from the interviews it becomes apparent that custodians that have a global footprint and are dotted across the globe can easily convince foreign clients in markets where they already have a presence simple because they are already known and have already established relationships and a track record. This tends to generate confidence and trust within the clients thereby making it easy for the client to move their investment to those markets where their custodian is present. The investors need adequate information to make informed investment decisions and it is on the basis of such information that the global custodian would learn about the opportunities in the Zimbabwean market through linkages with their sub-custodian in Zimbabwe. Commenting on the role of global custodians, one of the respondents from a custodian which is subsidiary to a global custodian said, “...*Usually it is very difficult to convince a foreign investor to come and deposit his securities with a bank that has no international flare which is not known in the international market.*”

The interviews also revealed that the main argument for partnering global players lays on the role they play in allaying investor fears for losing their investment or issues around opportunity cost of investing elsewhere. This therefore calls for local custodians to find ways of establishing international linkages and marketing their services and investment opportunities more aggressively. Partnerships with well-established international players can also boost investment inflows through the portfolio investment arena. Through these linkages the local custodian will also benefit in terms of infrastructure because these global custodians would want their affiliates to use the same systems they have and also do business in a particular way. Another responds also outlined this saying “...*so once we have that connection with the major custodians I think we can keep our game up to standard*”.

Alternatively all that the local custodians might need to do is to market their services abroad to at least become a sub-custodian of a foreign custodian as this would give them automatic access to the international market.

4.3.3.2 Infrastructural Issues

Infrastructural issues also emerged focusing on three third dimension sub-themes dealing with systems interoperability, access and connectivity issues and technology adoption. These are discussed in detail in the section that follows.

4.3.3.2.1 Systems Interoperability

This section analyses the responses that are aligned to the issue of interoperability of systems. All the respondents cited the issue of availability of appropriate infrastructure as one of the most important issues when it comes to the extent to which technologies can be transferred from developed economies to the local market. The respondents revealed that at the moment the CSD and the custody software are currently running as parallel systems which do not “talk to each other”, they are not interfaced and custodians have to spend additional hours updating their internal systems with transaction that would have gone through the CDS system during the day. There ought to be integration between these various systems to prevent duplication of efforts which would help reduce labour hours and associated costs.

Good systems are known for the ease with which they can be connected to communicate with other systems. However the main challenge is that such systems are often quite expensive. As revealed by the collected data the two custodians that are linked to international banks are sharing the systems and communication platforms with their parent custodian abroad. The main benefit is that such arrangement facilitates the much needed linkages and quick communications as well as the sharing of standard processes which tends to uplift the image profile of the local custodian. This is the model which the local custodian could adopt for median to long-term growth; they need systems that can be easily linked to other systems to avoid being rendered redundant for failure to synchronise with other systems. Linkage with international systems also facilitates easy and quick transfer of funds at the convenience of potential investors which becomes a strong luring factor to the world of investors. Continuous replacements of systems means continuous commitment of financial resources which tends to affect returns and cash flows.

4.3.3.2.2 Access and Connectivity

The respondents also described the role played by access and connectivity through information technology infrastructures as very crucial. They also highlighted the need to ensure that local processes and procedures match that of the developed countries in terms of speed, accuracy and up-time. When local communication networks are well connected it becomes easier to establish regional linkages and access to other markets. Fibre links or satellite connectivity to neighbouring stock exchanges can be a starting point for an effective and integrated platform for cross border trades. There have been a lot of improvements owing to work that has been done by the telecommunication industry to improve connectivity. However all the respondents insisted that what is now required are world class systems and platforms to operate on these computer networks. Internet connectivity costs and bandwidth charges are still on the higher side in Zimbabwe and if this is not addressed it will have a negative impact on the rate of technology adoption.

Respondents also indicated that connectivity in Zimbabwe is often hampered by erratic power supplies. Respondent also noted that despite the work that has already been done local connectivity is still not as fast as in competitors markets. When asked about their business continuity strategies they showed a high level of appreciation such that in most of their organisations designated areas were setup as business continuity offices so as to minimise disruptions to business. Communication and internet costs are notably higher compared to other markets which we compete with which tends to limit access to information. Access to information is what an investor wants to be able to counter information asymmetry which tends to discourage foreign investment. One respondent indicated that the high connectivity costs tend to force locals to access internet only during working hours after which the markets become unreachable. This is unlike developed countries where they operate for 24 hours to be able to access investors from different horizons. That flexibility is needed if custodians are to capture the markets that do not share the same time horizon as theirs.

4.3.3.2.3 Technology Adoption

The interviews also brought up issues to do with the rate of technology uptake or adoption in Zimbabwe as compared to other markets. The general sentiment among all the respondents was that although standards are slowly improving, companies normally purchase mediocre systems which are commensurate to their financial capacities. These are the systems that

normally have the serious technical problems which will in the end affect service delivery as well as lack in terms of interoperability. One respondent from a custodian linked to an international bank indicated that their communication platform is greatly enhanced through the use of SWIFT messaging platforms which facilitate instant encrypted messaging between themselves and their clients concerning corporate actions for instance. SWIFT has an arrangement whereby messages can be disseminated through participants and this is only possible if the custodian has systems that are SWIFT-capable.

There is therefore need to quickly close the technology gap that exists between the Zimbabwean market and the developed world. This can be achieved by adopting new systems and sound information technology infrastructure which have already been tried and tested in other developed markets, however this still boils down to the issue of availability of funds. Successful adoption of robust technologies will go a long way in improving the turnaround time as well as reduce errors. System and process automation by nature also helps eliminate excess manpower which in turn will help reduce overall costs of doing business thereby giving companies greater financial flexibility

4.3.3.3 Competition

An analysis was also given to help in assessing the nature and dimensions of competitive forces by looking at their related areas namely internal competition, external competition and the business “hunt”, that is, the search for new business. These are discussed below in greater detail.

4.3.3.3.1 Internal Competition

The respondents also highlighted the effect of both internal and external competition as well as their effects on the operations of the local market. Commenting of entry barriers in the custody market, the respondents pointed out that barriers do exist with the main one being the presence of already established brand names in the market and the time that it will take a new player to establish a footing in the local market before even mentioning the international market. The other issue is that there is need for great financial stability. The custody business is a technology driven business that needs constant capital injection to keep pace with new and better technologies so as to make their business models viable, a thing which small and new player may not be capable of doing.

Internal competition is good up to a point where it results in continuous improvement among the players due to the fear of losing business to a competitor. Inefficiencies among custodians may have serious and damaging reputational consequences. Hence in a bid to avert such consequences custodians need to put in place efficient systems, processes and procedures which are in sync with international best practice for them to be more appealing to investors. A healthy level of competition is crucial for the growth of any industry. Respondent 7 insisted that, “... *such competition which should predominantly be in terms of product and service offering as opposed to price wars which normally generate losses and company liquidation...*”.

4.3.3.3.2 External Competition

The issue of external competition also emerged in the discussions owing to the growth in influx of mutual funds from western countries to the emerging and developing markets in search for higher returns (Gonzalez 2009). It was pointed out by one of the respondents that this influx is being fuelled by the growth in pension fund portfolio owing to the aging population that is now a common feature among the western economies. This creates a great opportunity for Zimbabwe and other developing markets.

Commenting on the growing impetus relating to the harmonisation of custodian services as well as enforcing uniformity of contracts, the respondents agreed that harmonisation is good in light of the globalisation effect. This is crucial as this would easily facilitate cross border trade. However they were all against the issue of uniformity with respondent 10 saying, “... *but you should not underplay the role of competitive advantage which uniformity is bound to compromise. You cannot say the product offering of one custodian must match that of another custodian as this might undermine the sources of competitive advantages that differentiate one custodian from another*”. In terms of trade turnaround time Zimbabwe is lagging behind other developing countries that are already operating at T+2 compared to T+5 for Zimbabwe. The emerging markets are ahead mainly because they have better trading systems, better oversight over markets, even their investment processes are different hence the need to benchmark the local custodial business models with those in more developed financial markets.

4.3.3.3 Business “Hunt”

The respondents, mainly the stockbrokers and asset managers, said a few things about what they called the “business hunt”. Here they were referring to the process of reaching out of the country in search of new business. When asked pertaining to availability of incentives to attract investors all the respondents did indicate that they do offer incentives and they are usually linked to the size of business being brought in by the client. There the custodial service fees are tilted in favour of high value portfolio investments as opposed to smaller ones.

Basically it is easier for custodians to go and sell business in those markets where they already have links and a presence, the assumption being that since those clients of the same calibre have already invested with the same company in that market they can easily trust to do the same in another market. One of the interviewees, an asset manager indicated that the custodians are not doing much to gain new business territory saying, “...*a custodian can actually go and look for business and then tell the client that they can look for an asset manager for them to do the investing of the funds that they will be holding on their behalf but the challenge with our own custodians is that they have been very passive. The structure of our industry is that they get business from the asset manager so they do not actually take the incentive to do business on their own and then pass it on to the asset manager.* Such a two way business model is bound to help establish a healthy business model of interdependence.

4.3.4. Information Asymmetry

The theme regarding information asymmetry was not part of the initial themes identified in literature review sections (chapter 2) but was formulated to cater for crucial aspects on the role played by information in the investment circles. Various aspects cropped up from the interviews on the sensitive of information and the role of effective communication as a relationship building and control mechanisms in business relationships. This theme was further split into two sub-themes to assess the role of information dissemination and service level agreements. These are discussed in the sections that follow.

4.3.4.1 Information Dissemination

This aspect is meant to give focus on the importance of full disclosure of information through regular reporting arrangements to keep the investor abreast with the performance of their asset portfolios in order to ensure trust and transparency. This sub-theme was dissected

further into two third dimension sub-themes to examine the role of regular reporting and mechanisms to ensure reliability of reports. These aspects are explained in the sections that follow.

4.3.4.1.1 Regular Reporting

The data collected revealed that when investors commit their funds in a distant country they demand a lot of information regarding their investment as a compensatory measure for not being close to their investment. Respondent 1, a custodian, indicated that their clients need to be notified whenever a settlement is done and at the end of every month they send transaction statements as well as valuation reports to show them the movements that transpired in their account. Every time a trade is done the broker has to notify the client for guidance and confirmations and when it is a money market transaction the client expects a confirmation within 24 hours as well as a confirmation from the custodian once settlement is done. One stock broker explained this saying, “..... *when we do a trade we confirm with a client we have done the trade, also confirm with their custodian that we have done trade so that when the customer or the investor confirms with the custodian, they have got a match....*”

As part of a contractual agreement or service level agreement the investor can actually stipulate the structure of the report he/she wants and the frequency with which the report is needed. The availability of reporting skills and the custodian’s ability to meet the specific business reporting requirements of a client will also determine the extent to which a custodian is able to attract foreign clients. As one of the custodians said, “.....*the report should be as simple as possible and comprehensive enough so that the client would have all the information like on the click of a button.*”

4.3.4.1.2 Reliability of reporting

The respondents from custody firms also indicated that reporting is only the starting point because the investor is still interested in verifying accuracy and reliability of the presented reports in terms of the value of their assets. As revealed from the collected data the major part of the report is the variance analysis to show whether what the asset manager is reporting is in line with the assets held on behalf by the custodian. If there are any variances then they would need to be explained. The issues to do with compliance are also part of the report to guarantee adherence to best practice as well as local requirements.

In order to enhance the reliability of reports and the information communicated to the investor respondent 5 from a sub-custodian indicated that they have an independent data provider who gathers data independently and updates the system as opposed to having custodian capture market data on their own. This is done to avoid overwhelming the custodians with work thereby making them more prone to errors. This respondent highlighted that the standard is uniform and standard across all the subsidiaries of that global custodian. This goes a long way in convincing a client about the company's commitment to supplying accurate data and sends a positive message about the quality of reporting done by the company.

4.3.4.2 Service Level Agreements

Service level agreements were identified as a separate aspect when looking at the role they play in defining business terms and condition between custodians, the investor and other players. These are discussed under two third dimension sub-themes namely dual agreements and oversight role of custodians. These are outlined in detail below as obtained from the collected data.

4.3.4.2.1 Dual Agreements

Respondents from both the custodians and asset managers indicated that some clients operate a dual agreement arrangement whereby they request more or less the same type of information from both on stipulated intervals for comparison purposes. The reporting requirements of a custodian may also be set to revolve around the investment mandate given to the asset manager by the investor to be able to check whether the asset manager is doing things as per investor guidelines. The investment mandate will also form part of the report to enable the custodian to report any deviations from the investment mandate as well as to get feedback from the investor on whether there was an adjustment to the investment mandate to allow any deviation from the original mandate.

The parallel reporting arrangement by the asset manager as well as the custodian is usually meant to give the investor the opportunity to compare the two and quickly identify any anomalies. Custodians do go a long way in protecting the assets of the investor and one of the custodians summarised an important incident below;

“Yes we are checking what the asset manager is doing and we can reject some of their instructions if they differ from those of the client. For example there was a time when asset

managers would ask us to deposit money directly into their account with the aim of pooling funds so that they may negotiate a better return. The issue however then came back to us because once the investment is bulked in a nominee account and they are given one security so they couldn't give us that security because there were other clients that did not belong with asset held by other custodian so we had to stop that so that each and every client has his or her securities which we are holding in terms of that investment”

The above narrative does capture the checks and balances which most foreign investors would cherish. The adoption of similar standards to protect an investment does reflect positive on the control environment prevalent in a given market.

4.3.4.2.2 Oversight Role

Questions were asked regarding the oversight role of the local custodians as is prevalent in other markets and the general sentiments were that though it is not expressly stated, this role is implied in the responsibilities that a conferred to the custodian. The main reason why the role is rather indirect is the fact that a proper oversight role would need to be applied across all the activities that are done by the asset manager. This would mean the custodian would need to employ economic analysts and the like in order get the full picture, this however would compromise the low cost model adopted by most custodians. What the investor then does is to give the custodian reporting requirement that would give oversight over areas of interest namely asset valuation and trading patterns and behaviour.

However as indicated earlier the other reason why the overall oversight role is difficult to implement in Zimbabwe is because business is coming from the asset manager going to the custodian. In such a situation the asset managers tend to have greater influence over the custodians because they can easily take away their business from the custodian. In a way however the custodian model already confirm the oversight role of the custodian by giving the mandate to oversee the movement of funds and the right to decide when and whether to release funds towards a settlement. This role also tends to give foreign investor the much needed assurance of the safety of their financial assets. In addition, the fact that most custodians are linked to banking institutions also give the investor extra comfort that since well capitalised and well managed banks are trusted and believed to be stable and well-experience to foreseen risks to mitigate potential losses.

4.4 Discussion of Results

This section focuses on the comparing research findings on the role of financial custodians with what is said in literature as reviewed in chapter 2 within the Zimbabwean context. Firstly the issues that brought much attention towards the custodial service business in the developed countries and in Zimbabwe are the same especially the issue of fraud and risk. In the developed countries it was in the form of re-hypothecation of securities which led to uncontrollable lending and exchange of securities thereby creating an asset bubble which inevitably had to burst, creating chaos in the securities markets and financial losses (Singh & James, 2009). In Zimbabwe what triggered this focus was mainly the adoption of a wrong model altogether namely the stockbroker model which was a legacy of historic practices. This model undermine or overlook the importance of segregation of roles among the market players thereby giving the stockbroker excessive market power which later degenerated into chaotic misappropriation of funds and lack of accountability which resulted in final losses as well (Government of Zimbabwe 2010). Unlike in the developed economies security lending is not allowed owing to the risks which it involves and also because of the absence of risk hedging instruments in the local market.

In terms of the roles that are performed by custodians the results agree to a great extent with what was discussed in the literature review chapter. The role of custodians in safekeeping of securities and settlements continue to dominate the custodians' roles in Zimbabwe. There is however very little scope in the Zimbabwean market at the moment in terms of value adding services. While according to literature value adding services are viewed to be anchoring the future of the custody business. This does not show in the Zimbabwean market mainly because the custodian model is still a new concept and still in its infancy with the CSD having been launched in 2014. The number of players as well as the market is also relatively small though with great growth potential. The absence of value adding services such as security lending as well as portfolio risk analysis and reporting and tax administration was noted during data collection. The absence of security lending guideline and legal frameworks and the narrow range of available financial instrument justifies the status quo. Without a proper framework more sophisticated financial services and products could introduce new dimensions of risk which the market currently has no capacity to handle. Services to do with portfolio performance and analysis reporting are handled by asset managers as opposed to custodians in Zimbabwe while taxes are withheld at source.

The literature discussed in chapter 2 also includes stockbrokers among the list of custodial service providers contrary to what the results can reveal. In Zimbabwe the stockbroker is at the upstream of the value chain and are restricted by law from offering custodian services due to weaknesses that were noted in that particular setup. Literature also pointed out that other than securities custodians also provide custody of other thing such as precious metals and properties. The market is currently dominated by demand for securities given that the safekeeping of other assets such as precious metals is restricted to a few licenced institutions, for instance gold and diamonds are controlled by the central bank. This tends to reduce the scope of custodians service offerings.

The results also bring out the issue of dematerialisation of securities and while literature reveals two options namely compulsory and voluntary dematerialisation the securities exchanges authorities opted for the latter. The drive towards this move was not necessarily motivated by failure to cope with securities trading volumes given that the trading volumes are not that huge. However the results can reveal that Zimbabwe was lagging behind other neighbouring countries some with even smaller exchanges compared to Zimbabwe. The prevalence of most securities in electronic form (dematerialised form) in the region and among countries that used to invest in Zimbabwe tended to compel Zimbabwe in order to maintain competitiveness in the market. In agreement with literature the results show a direct link between dematerialisation and trading efficiency, increased participation (still anticipated in this case) and risk reduction. This is crucial if Zimbabwe is to position itself well to attract investment inflows.

Literature is not silent about the role of custodians in settlements and the complexities that can be involved in cross border investments in securities (Goldberg et al. 2002). The results can reveal that the Zimbabwean market has not fully managed to put a rein on the settlement process which evidence suggests is the main bottleneck in the securities trading cycle which over the years had been pegged at T+7 and has improved by 2 days to T+5. This is less competitive compared to other markets that are already at T+2. This disparity affects the attractiveness of the local market to potential investors as this ranks the market poorly in terms of market immediacy which is a key performance measurement of market efficiency. The Zimbabwean market is also characterised by high transaction costs starting from the brokerage fees, asset management fees and also custody fees. There are also funds transfer fees as well as investment related levies and taxes which an investor is also subjected to

hence in terms of tightness the market is also not very competitive. The liquidity of the market is also affected by the prevalent high interest rates which make it very costly for dealers with short positions to borrow funds on a short-term basis.

Contrary to the position taken in a study by Osler et al. (2012) that defined custodians as lacking in terms of transparency and overcharging clients, the results showed that custodians in Zimbabwe actually use transparency as a selling point for their services. Their charges are negotiated beforehand and agreed on by way of service level agreements and their charges are usually based on asset portfolio values which the investor checks and verifies from time to time. The lack of transparent is more prevalent and applicable to other range of financial services and products that are not yet available in the Zimbabwean market namely derivatives.

There are other value adding services that are offered by custodians in other markets namely shareholder services such as share warrants and swaps as well as the roles in administering share buyback schemes, cited in literature which is not prevalent in the Zimbabwean market. This is because the results indicate that the market is characterised by the very basic security instruments such as equities and money market instruments. A growth in that direction will also expand the product offering in the market and create variety to suit a wider range of investors' risk appetites. However with the various employee share ownership schemes that came as a result of the indigenisation laws in Zimbabwe none of the respondents confirmed their involvement in such scheme contrary to what literature suggests to be happening in other markets. This could be an area which custodians may also need to explore and even extend such services to markets outside Zimbabwe.

Looking at the various risk exposures discussed in literature the results also confirmed their presence in the Zimbabwean market. However in Zimbabwe country and political risk tends to have a dominant effect over the other risks. The operational risk human error in particular is a major issue that has been causing serious inefficiencies. However with the automation of securities trading the risk of human error can be reduced significantly. The automation has created a lot of hope in terms of the country's ability to attract foreign portfolio investors. Credit risk which according to literature is dominant in markets where security lending is practiced is also present in the Zimbabwe market despite the absence of securities trading. Results show that this risk is being propelled by the use of securities as collateral for loans

issued by banks. This practice is also propagating another risk namely liquidity risk because of lack of adequate regulation regarding protecting the lender from an unexpected fall in the value of the assets which could render the assets inadequate to cover the outstanding loan balances.

Strategic risk was not expressly mentioned in the data that was gathered though it is implied in the sub-theme relating to systems interoperability where it was observed that some custodians are investing in mediocre systems that adversely affect their operations in the long run. Legal risks are also present by virtue of the absence of adequate regulation to deal with security collateralisation. However the legal framework regarding the recognition of securities in electronic form was adequately covered and directors of the affected companies were required to amend their articles and memorandum of associations to recognise the change though of a voluntary basis. Systemic risk, a risk discussed in literature that emerged through the coming in of securities trading automation and the CSD. This is caused by the use of a single system by all players and any technical problem on the CSD system could paralyse the whole trade cycle. However the results showed great awareness with regards the risk associated with financing of terrorist activities and blacklisted persons as well as money laundering which was not covered much in literature.

A lot was said in literature with regards the protection of investors' assets or investments, namely IOSCO (2014). In Zimbabwe the adoption of the custodian model made it mandatory to segregate and be able to identify individual investor's assets. As revealed in the results the danger of failing to clearly distinguish individual's assets is a risk which most investors are not prepared to bear and could easily drive investors away. In addition, with regards to whether self-custody is best practice, both literature and the results remained inconclusive owing to the subjectivity of the matter given that the issue really depends on issues of corporate governance, ethics as well as professionalism.

There is an argument in literature which describes foreign portfolio investment as a cheaper source of capital for developing countries and it being cheaper means that the demand for it has been constantly growing. This therefore calls upon the Zimbabwean market to be well positioned to attract this capital. This implies the need for Zimbabwe to eliminate other risks that contribute to the country's overall risk because the more the risk created the higher the expected return from potential investors and some risk intolerant investors would even shun

the market. There is need to work on improving investor confidence by any means possible. The absence of derivative instruments in the Zimbabwean market could actually work for the good of the country. This is because most hedging instruments tend to attract speculative investors in the short run. These are not the types of investors Zimbabwe is looking for. As put across in literature, foreign portfolio investment that is backed by speculative behaviour might result in sudden reversals of capital inflows which could leave a country in a more fragile state than before (Dua & Garg 2013).

On the relationship between foreign portfolio investment and foreign direct investment literature indicated that foreign direct investment in a country is a catalyst to the influx of foreign portfolio investment (Gozgor, 2010). This is however contrary to the situation in Zimbabwe where foreign direct investors are actually pulling out of the country. However, Table 1.2 in Chapter 1 shows what is contrary to that assertion. The statistics are showing that despite the pulling out of some investors, foreign investment inflows were actually on the rise between 2010 and 2013. This therefore renews the hope that provided the country works on perfecting the custodial service operations and putting in place the relevant infrastructure, there is nothing that can stop the upward trend from persisting even on a high scale if conscious effort is put by all stakeholders including the government.

As indicated in the case of Malaysia, self-transforming policies were adopted by the government to consciously create a hub for foreign portfolio investment. In the same way the market can also take the opportunity to exploit the checks and balance, the risk mitigating effects and the linkages that can be created through the custodian model as well as the investor confidence that it is bound to generate. In line with Lucas' (1990) argument, it is the extent to which a poor country is prepared and willing to create conducive environment that will stimulate foreign capital inflows. Some countries cited in literature had to improve their infrastructure and connectivity with other exchanges before foreign portfolio investment started pouring in and this is the same strategy which Zimbabwe can also ride on through the mechanisms available in the custodian model discussed above. Therefore based on the above finding and discussion the proposition that the ability of local custodians to mitigate securities trading risk and improve trading efficiency will increase foreign portfolio investment into the Zimbabwean market is upheld.

4.5 Chapter Summary

The collected data was subjected to template analysis to which seeks to categorise data into themes and into codes and sub-themes which help explain the themes. A 75% response rate was achieved with 15 out of the targeted 20 managing to show up for the interviews. The iterative process of grouping data and defining its categories was done based on three *a priori* themes deduced from literature namely, custodial service attractiveness, risk and risk mitigation, and global integration. Following through analysis a new theme cropped out of the data which could not be described and analysed in the existing categories namely information asymmetry. The role of information asymmetry in making investment decisions is crucial and measures need to be put in place to ensure that this is addressed adequately if the country is to be able to attract the much needed foreign portfolio investment. Following thorough analysis of the template elements it was observed and concluded that the proposition that the role of custodians can be harnessed in a manner that can result in capital inflows coming into the country. The chapter that follows concludes the research by looking at study limitations, areas of future research and recommendations to stakeholders.

CHAPTER 5

DISCUSSION, CONCLUSION AND RECOMMENDATIONS

5.0 Introduction

The study focused on analysing the role of financial custodians in the promotion of foreign portfolio investment. The study was prompted by an unusual phenomenon whereby there was a notable increase in the foreign investor trade on the ZSE between 2010 and 2013 while at the same time numerous companies were closing shop and investors pulling out of the country. Government has for decades been calling upon investors firstly from both the western and eastern economies for foreign direct investment and efforts continue to be channelled towards developing strategies to attract foreign direct investment (Ministry of Finance Zimbabwe 2011). However there has been significant disinvestment as opposed to the much needed foreign direct investment. This study has sought for an alternative option of attracting the required capital inflows namely through foreign portfolio investment through analysing the role which can be played by financial custodians whose functions are central to the dynamics of portfolio investment not only in the Zimbabwean market but throughout the world.

At the end one must be able to look back and map out an investment policy based on issues around the efficiency of custodial services delivery systems and channels, issues around risk profiling and risk mitigation as well as issues around global integration of local custodial services. In other words this study seeks to tell the reader how the custodial services can be harnessed efficiently to combat and mitigate risks in order to connect the Zimbabwe securities market to long term foreign portfolio investors. The result of this study would help in making available capital at low cost as well as bring a long term solution to the liquidity crises without accruing debt but by following practical principles that have been tried and tested in other markets.

5.1 Summary of Findings

The in-depth interviews that were conducted on 15 managers from the four “wheels” of portfolio investment namely custodians, asset managers, stockbrokers and settlement banks revealed a number of insights for policymakers and the players in the securities market of Zimbabwe. At the highest level the study reveals that custodians have the potential to attract foreign portfolio investment and this potential can be released through placing focus on

service attractiveness and excellence, employing robust risk identification and mitigation mechanisms, establishing global market linkages and eradicating information asymmetry. The second level is how can they achieve service attractiveness and excellence without ensuring service diversity, service efficiency and continuously interrogating their service value chain for continuous improvement? How can they identify and mitigate risks without awareness of their risk exposure and enforcing risk controls? How can they connect to the global market without associating with global custodians, building enabling infrastructures, and generating resistance against competition? Finally how can they eradicate information asymmetry without full information disclosure and with service level agreements to enforce timely and accurate disclosures?

The results therefore reveal that in order to assess service diversity one needs to look at the depth and breadth of service range as well as the suitability of the services offered in view of investor demand. Service delivery efficiency is attained by evaluating the turnaround time or turnover rate, scrutinise and identify gaps in the processes and procedures and resolve them as well as ensuring that the investor's interests are well protected and catered for. It is also notable from the results that for the value chain to remain relevant one need to continuously appraise the contribution of the value chain participants as well as explore opportunities for synergies along the value chain. In terms of risk exposures there is need to identify the risks associated with the agency problem as well as identify and profile the risks that are associated with the service provided. It is important to explore all risk control options namely through legislative controls, technology or system driven controls or structure or process driven controls.

Concerning global custody results reveal that one can establish a global presence through subsidiaries or sub custodians or through affiliation to global custodians. To promote lateral expansion, infrastructural issues need to be addressed and these revolve around interoperability of systems, the issue of access and connectivity as well as adoption of new technologies. The global market is characterised by intense competition and the only way to beat the competition there need is to continuously assess both internal and external competition and then map a path for a business "hunt". Finally the results revealed an additional theme which was not part of the original *a priori* theme namely information asymmetry and the role it plays in the investment and custody business. Information asymmetry can only be dispelled through adequate information dissemination through regular

reporting as well as putting checks and balances in place to guarantee the reliability of reports. Service level agreements can also be designed to enforce dual control and oversight.

5.2 Conclusion

This study vindicates the assertion by Lucas (1990) that a country has a role to play to trigger a downhill movement of capital inflows. The final template (Appendix A) from the gathered information summarises the key investment and custodial services aspects drawn from the vast experiences of selected managers from the “four wheels” of portfolio investment in Zimbabwe. It can therefore be concluded that financial custodians can play a crucial role in promoting foreign portfolio investment inflows in Zimbabwe in the medium to long-term. In order to achieve attract the foreign portfolio investment inflows there is need to mobilise resources needed to establish the required systems, standards, technologies and infrastructure discussed above.

5.3 Recommendations

In view of the results of this study it can therefore be recommended that;

- i. The concepts that are developed and summarised on the Final Template (Appendix A) be used as the basis of a starting point for assessing the custodial services sector for policy making purposes in view of the desire to attract foreign portfolio investment. The themes and sub-themes need to be applied as a benchmark or comparative template to assess how Zimbabwe compares with other markets in Southern Africa. Such an approach will assist in assessing the gaps that needs to be filled to become competitive in luring foreign portfolio investors.
- ii. Policymakers and relevant authorities need to pool resources together and prioritise the building of the required computer network infrastructure and communication links linking Zimbabwe to neighbouring countries. As discussed in a study on corporate bonds in Malaysia (Ibrahim & Wong 2006) where Malaysia embarked on an intensive financial infrastructure development programme to introduce computerised trading platforms, Zimbabwe can also lure portfolio investors in the same way thereby increasing capital inflows into the country.
- iii. There is need to start considering the integration of countries within regional blocks like SADC so that they can create a fund to finance the integration of settlement systems, security depositories and securities trading systems. The case of the Hong Kong Monetary Authority (HKMA) discussed above shows that sophisticated

technology is not enough. In addition to these systems there still remains the need to link up with system in other countries to accrue relevance in global trade (Kame 2014). Through the implementation of internationally renowned standards and platforms such as DVP and PVP, Hong Kong managed to enhance its attractiveness to investors and affirm its safety in trade settlements. Zimbabwe can achieve this by working towards sharing trading platforms with other developed markets in Africa namely South Africa and spread the platform throughout the rest of Southern Africa and ultimately throughout Africa and the rest of the world.

- iv. Local custodians need to consider expanding their services and product lines to include employee share ownership schemes and management share ownership schemes. There is also need to invest in developing skills in risk management in a bid to enhance custodians' capacity to handle and mitigate risk exposure that are inherent in financial markets. This can be done through introducing risk management courses in universities and colleges as well as organising secondment of staff to group companies in more sophisticated markets in Africa and other developed countries.

5.4 Limitations to the Study

In view of the circumstances within which the study was done as well the research design that was adopted the following are the limitation to the study;

- i. The study chose a judgemental sampling and qualitative approach whose main limitation is the generalisability of the research findings and subjectivity. However the issue of generalisability might not have significant impact on the results because the study was conducted with Zimbabwe in mind and with the key players in the portfolio investment arena and there was no intention to apply the results to the context of another country outside Zimbabwe. The other issue is that the sample targeted managerial staff to have enriching discussions through tapping into the managers' wealth of years of experience so as to obtain valid and reliable responses.
- ii. The study was conducted at a period where there were new developments that were being introduced in the market namely the implementation of the CSD and the automation of securities trading at the ZSE. This made it difficult to assess the effects of the automation as well. As a result the study was deliberately designed to exclude that part of the assessment even though assessing this would have given a more complete picture. This exclusion however was also justified by the fact that the

changes also needed to be given time to settle and stabilise before a valid assessment could be done.

- iii. The study was conducted on a cross section basis as opposed to longitudinal assessment. This means some of the developments that happened over a period of time could have been missed. This data collection approach, namely the in-depth interview was preferred to take advantage of flexible questioning to probe into any such perceived grey areas so as to validate the research outcomes.

5.5 Areas for Future Study

In view of the above limitations one aspect that might need attention to have the same research done using a longitudinal timeframe to enable a before and after automation comparison. It would also be useful to include ZSE and Chengetedzai CSD officials as part of the interviewees. In order to make the comparison more meaningful it might be useful to use a 5 year before and 5 years after automation analysis of performance measures and foreign investor participation.

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Appendices:

Appendix A

THE FINAL TEMPLATE

| First Dimension : Themes | Second Dimension: Sub-themes | Third Dimension: Sub-themes |
|--|-------------------------------------|--|
| Custodial Service Attractiveness: | Service Diversity | 1.Service Range 2.Service /Product Suitability |
| | Service Efficiency | 1.Turnover rate 2.Processes and Procedures 3.Investor Protection and liability |
| | Service Value Chain | 1.Value Chain Participants 2.Service synergies |
| Risk and Risk Mitigation: | Risk Exposure | 1. Risk and the Agency problem 2. Risk dimensions in custodial service provision |
| | Risk Controls | 1.Legislative controls 2.Technology driven controls 3.Structure driven control |
| Global Integration: | Global Custody | 1.Global footprint 2.Global Affiliation and confidence |
| | Infrastructural Issues | 1.Systems Interoperability 2.Access and connectivity 3.Technology adoption |
| | Competition | 1.Internal Competition 2. External Competition 3.Business “Hunt” |
| Information Asymmetry: | Information Dissemination | 1.Regular Reporting 2.Reliability of reporting |
| | Service Level Agreements | 1.Dual Agreements 2.Oversight Role |

UNIVERSITY OF ZIMBABWE



INTERVIEW GUIDE

FACULTY OF COMMERCE

GRADUATE SCHOOL OF MANAGEMENT

My name is Muchapaziva Begede and I am a student from the University of Zimbabwe, Graduate School of Management doing a Master's in Business Administration (MBA) degree program. I am carrying out a research study on **the Role of Financial Custodians in Promoting Portfolio Investment in Zimbabwe**. I kindly ask for your assistance with the information required to make the research a success. Any information you provide as well as your personal view will be treated with strict confidentiality and used for academic purposes. Your contribution to this study will be greatly appreciated.

Thank You.

Company Profile:

- 1) Name of firm _____
- 2) Year of Establishment _____
- 3) Staff Complement _____
- 4) Your position in the firm _____

1. Custodial Service Delivery System In Zimbabwe:

i. Functions and responsibilities

Tick the services which are provided by custodians in Zimbabwe in the space provided below;

| Functions/responsibilities | Tick |
|---|-------------|
| Safe-keeping of securities | |
| Recording keeping, documentation handling, investment accounting, etc | |
| Settlement of security trades | |
| Customized Client reporting | |
| Information dissemination and responding to corporate actions | |
| Exercising of voting rights eg via proxy | |
| Collection of asset related income receivable – interests, dividends | |
| Tax administration & advisory services eg tax claims | |
| Monitoring & overseeing Asset Manager activities & compliance | |
| Monitoring Asset Manager’s compliance with contract guidelines | |
| Independent asset portfolio valuation | |
| Checking Asset Valuation computations of Asset Manager | |
| Lending of security under custody | |
| Approving Asset Manager’s security borrowers for collateral adequacy | |
| Portfolio management appraisal | |
| Cash flow management | |

Other (specify).....

Can you comment on why those you have not ticked are not being provided locally.

.....

ii. **Efficient in the custodian service delivery system**

- Turnaround time for transaction processing – tick applicable

| | |
|-------|--|
| T+1 | |
| T+2 | |
| T+3 | |
| > T+3 | |

What is best practice and what could be reasons for any deviations from best practice if any.....

- System Related Problems – tick applicable

| | |
|---------------------|--|
| Power Related | |
| Connectivity | |
| Business Continuity | |
| Vendor Support | |

In your opinion what do you think needs to be done to attain maximum efficiency comparable to world class standards – in terms of system driven processing efficiency

iii. **Attractive of custodial service offerings to Foreign Investors**

Based on standard custody agreements and investment governing laws in Zimbabwe do you think a custodian can be held liable for the following failures? Yes/No

| | Yes/ No |
|---|---------|
| The Asset manager purchases securities in breach of client guidelines. The value of these securities falls and generates a loss which the asset manager is unable to cover. | |
| Asset pricing errors by the asset manager are revealed after a number of years. | |
| Failure to collect Dividend & Interest income and make tax refunds claims. | |
| Delayed response to a corporate action which translates to a loss for clients. | |

| | |
|---|--|
| Securities delivery before receipt of payment and the counterparty defaults which sees client incurring losses. | |
| Client securities are lent against insufficient collateral and they are not returned. | |
| Overseas sub-custodian fails to settle a transaction and Client loses. | |
| The Asset manager uses client funds to cover own loss position but eventually fails to return the funds. | |
| The Asset manager falsifies portfolio performance by shifting securities between client accounts to give a favorable picture and all client accounts are with same custodian. | |
| The Asset manager overcharges its clients on brokerage commissions and this is discovered later. | |
| The Asset manager engages in activities that result in excessive management fees to its clients and this is discovered later but the custodian does nothing about it. | |

iv. In your opinion what are the main regulatory deficiencies that need to be addressed with regards to;

- Custodians
- Asset Managers
- Stockbrokers
- Settlement banks

v. Do foreign portfolio investors pay fees at the same rate as locals in terms of taxes, custodial fees and levies? Please explain

.....

vi. Does your company belong to a group that offers both custodial and asset management services? Yes ___ No ___

vii. If yes does it provide self-custody i.e. custody of your client's assets being done by your own company?

.....

viii. In your opinion what needs to be done to improve service delivery to international standards in the custodial service business?

.....

2. Risk Exposure in Security Trading, Settlement and Security Custody:

On a scale of 1-12 (where 1 =most prevalent and 12 = least prevalent

| Risk Areas: | Ranking |
|---|----------------|
| Security theft | |
| Fraud by asset manager | |
| Costly errors in trading | |
| Failure to secure best price for client | |
| Delays in settlement and errors | |
| Pricing and valuation errors | |
| Operating beyond client guidelines | |
| Counterparty default risk | |
| Delays or failure to collect income | |
| Delays or failure to respond to corporate actions required. | |
| Management fee computational errors | |
| Improper securities lending approvals | |

Please specify other risks

.....

- i. What risk mitigation measures have been put in place in your company as well in Zimbabwe?

.....

- ii. Are you aware of an control measures which are being implemented else which may need to be adopted in Zimbabwe to mitigate risk? Explain

.....

3. Global Integration of Security Trading and Settlement Systems:

i. Which types of custodians dominate the Zimbabwean Custodial industry and why?

Single market custodians – confined locally

Multi – direction custodians – target regional markets

Global Custodians – presence in at least 100 markets

ii. Are there any entry barriers in the custodial services business?
Explain.....

- iii. In your opinion is it important or what are the benefits of being affiliated to Global custodians to the local market?
.....
.....
- iv. Does the existing infrastructure adequately support cross border security trading and settlement. State any necessary issues that need to be addressed to improve the current status.
.....
.....
- v. Do you think need to be done to increase global participation of local custodians.....
.....
- vi. What is your comment on proposals to harmonise custody regulations and uniformity in custodian contracts?
.....
- vii. In what way do you think custodial services could be used to attract foreign portfolio investment to Zimbabwe?
.....
.....
.....
.....