



Reforms in Custodian Banking

A report by



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Reforms in the Custodian Industry

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Executive Summary

There is an urgent need to review and reform the operations of India's custodian services of securities. For too long the issue of custodian banks has been pushed from one desk to another. Rising FPIs inflow combined with better integration with the global markets means that India must prepare and strengthen this crucial part of India's financial infrastructure and make it globally competitive

This can only happen if the Reserve Bank of India issues a new set of licenses for specialized India-based custodian banks. It is important that India opens up this segment of licenses so that domestic capability and capacity can be built up in this area.

In this working paper, the first from the Centre of Innovation in Public Policy in collaboration with the Institute of Competitiveness, we present the current state of custodian services, the restrictive trade practices that have led to the creation of a foreign bank oligopoly, and how reforms in the segment will reduce the cost of investment, and increase the diversity and depth of foreign flows.

Custodian Services Overview

What are custodian services?

A custodian is a specialised and critical financial institution that holds a customer's securities for safekeeping and protects them against misappropriation, theft, misuse, or loss. The custodian may hold securities in electronic or physical form. Over time, custodians have evolved from their traditional role of safekeeping to offer a plethora of banking services. Custodians around the world primarily offer three distinct services:

- i. Safekeeping of assets: maintaining formal records of ownership, valuation, accounting, and reporting of assets owned by a plan/fund sponsor or an institutional investor;
- ii. Trade processing: tracking, settling, and reconciling assets that are acquired and disposed of by the investor, either directly or indirectly, through authority delegated to an asset manager;
- iii. Asset servicing: maintaining all economic benefits of ownership such as income collection, corporate actions, and proxy issues.

A custodian is not the owner of a client's asset but is empowered to act on behalf of the client. The custodian is often referred to as the gatekeeper of assets whose function is to track monies and assets moving into and out of the account and renders regular financial valuation of such assets held in custody.

A few banks in North America have in recent years re-invented themselves as 'specialized custodian banks', offering core custodian services and limited regular banking functions. BNY Mellon, State Street Bank, Northern Trust, Brown Brothers Harriman, and others have created specialized services for global investors across the world.

As of 2019, the value of the global custodian market stands at USD 30.7 billion with a CAGR of 5.8 percent, North America was the largest custodian market in 2019 accounting for 52 percent of the total value of the custodian market. That market is expected to grow another USD 1.2 billion by 2023 on the back of global growth of various custodians.

The world's top five custodians--BNY Mellon, State Street, JP Morgan, CitiGroup, and BNP Paribas--account for roughly 60 percent of market share. Four of these are US companies.

Specialized custodian banks have not developed in India due to regulatory hurdles. This has limited the depth and diversity of India's capital markets because custodian services are supplementary to regular banking. That makes the custodian market in India qualitatively different from what is being offered in the rest of the world, stifling global investments into India as we explain later in this paper.

Custodian services in India

According to capital market regulator SEBI, India has 19 financial institutions that offer custodian services. It is necessary to obtain a certificate from SEBI to offer these services. Currently, only full-service banks and non-bank custodians are certified to offer custodian services in India.

The regulatory framework for custodian services in India has not kept pace with global developments. While the US and other countries have both universal banking custodians and specialized custodians banks, India has universal banks and non-bank custodians that cannot offer services such as deposit accounts and foreign exchange services to their clients. This creates a challenge: Foreign Portfolio Investors (FPIs) do not choose India's universal banks offering custodian services due to high risks of NPAs on their balance sheet and home-country regulations prevent them from using India's non-bank custodians. This relative absence of competitive offerings causes systemic inefficiencies in the system and raises operational costs for FPIs.

In 2016, in its first bi-monthly monetary policy statement, the RBI commented on the need to explore increasing the scope of differentiated and niche banks such as wholesale finance banks and custodian banks. A report for discussion was scheduled to be released in September of that year.

However, released at that time was a brief statement: "After detailed deliberations, it was felt that no significant advantage will accrue by introducing custodian banks at this point of time. Hence, a discussion paper on 'Wholesale & Long-Term Finance Banks' (WLTF) has been prepared and released for discussion"-- custodian banks were specifically kept out.

Custodian players and market size

The Indian custodian space is dominated by MNC banks. Of the 18 custodians in India, 8 are foreign banks and 5 domestic private banks. The remaining 5 custodians are non-banks that are, due to regulations, compelled to avail the assistance of domestic banks for the banking leg of the transaction.

MNC banks with significant presence are Deutsche Bank, Citi, JP Morgan, HSBC, and BNP Paribas. Effectively, no public sector bank offers custodian services, the closest being SBI offering services through its joint venture subsidiary with Societe Générale, namely, SBI-SG Global Securities Services Ltd. According to industry sources, the AUC under custody of the MNC banks largely driven by FPI custody in India, is estimated as follows:

1. Deutsche Bank: USD 235 billion
2. Citibank: USD 190 billion
3. JP Morgan: USD 110 billion
4. HSBC: USD 5 billion

Because of their monopoly with FPIs, client cash balances of these MNC banks are estimated at USD 7 billion. On the turnover and assets under custody of FPIs, the income accruing to foreign banks is nearly USD 1 billion, broken down as given below:

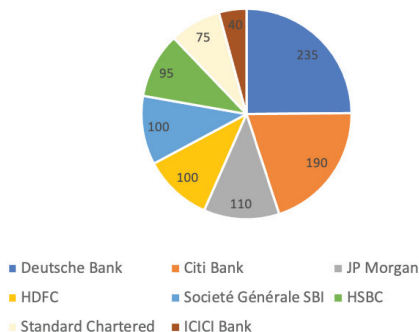
Fee income: INR 668 crore

Interest of client funds: INR 3,134 crore

FX income against gross forex flows: INR 175 crore

Fee against FPI derivative clearing: INR 3,231 crore

AUC Share (in billion dollars)



Custodial bank licensing in USA

Custodian banks were set up under the Investment Company Act of 1940 for protecting investors. Supervised and examined by a state or federal authority, a custodian bank acts as a third-party watchdog for safeguarding the assets of a firm or individual from prospective illegalities of a fund manager.

The specific requirements related to an insurance company's utilization of systems for holding and transferring securities are included in the USNAIC's Model Act on Custodial Agreements and the use of Clearing Corporations (Model # 295) and the NAIC's Model Regulation on Custodial Agreements and the use of Clearing Corporations (Model #298). When conducting financial examinations, custodial or safekeeping agreements should be considered and evaluated based on these following guidance:

1. An insurance company may, by written agreement, provide for the custody of its securities with a custodian. If permitted by the state of domicile, the custodian must either be a broker/dealer that is registered with and subject to jurisdiction of the Securities and Exchange Commission, maintains membership in the Securities Investor Protection Corporation, and has a tangible net worth equal to or greater than USD 250,000,000; or a national bank, state bank, or trust company which is adequately capitalized and qualified to accept securities as determined by the standards adopted by the US banking regulators and regulated by state banking laws or a member of the Federal Reserve system.

This means that while India allows foreign custodian services to operate in the country, Indian non-banking custodian services cannot provide services in the US; only custodian banks can do so in that country (emphasis ours).

2. Custodial or safekeeping agreements with an agent, or clearing corporation meeting the requirements herein should contain satisfactory safeguards and controls including, but not limited to, the provisions given below. For the purpose of this guidance, an agent is a national bank, state bank, trust company or broker/dealer with an account in a clearing corporation, or a member of the Federal Reserve System. A clearing corporation is a corporation as defined in Article

8 of the Uniform Commercial Code that is organized for effecting transactions in securities by computerized book-entry, including the Treasury/Reserve Automated Debt Entry Securities System (TRADES) and Treasury Direct book entry securities systems, except those securities issued under the laws of a foreign country.

The relevant portion of these regulations are, “The foreign bank acting as a custodian, or a US custodian’s foreign agent, or a foreign clearing corporation is only holding foreign securities or securities required by the foreign country in order for the insurer to do business in that country. **A US custodian must hold all other securities” (emphasis ours).**

Custodian services structure in India

Unlike international markets, India does not have specialized custodian bank services providers (either foreign or local) that can act as a one-stop shop for the custody and banking needs of institutional clients.

The Securities and Exchange Board of India (SEBI) is the primary regulator for custodians in India. Any institution proposing to provide custody services in India must be granted a certificate from SEBI. At present, full-service banks and non-bank custodians provide custody services in India.

India initially had a couple of non-bank custodians and a few foreign banks. As custodian services accelerated following the dematerialization of securities in the late-90s, more foreign banks joined the existing custodians. Gradually, with the increase in foreign and domestic investments, Indian full-service private banks and a few other non-banks applied for a custodian license to SEBI and entered the market. Now full-service banks (foreign and Indian) and non-bank custodians provide custodian services in India.

Full-service banks

- As of March 2020, India had 86 full-service banks (foreign and Indian). Of these, only 13 banks are registered with SEBI to offer custodian services.
- Of the 13 banks, five are domestic full-service banks and eight foreign full-service banks. The latter dominate the FPI market for custodian services. Indian full-service universal banks are not the preferred choice of FPIs.

Non-bank custodians

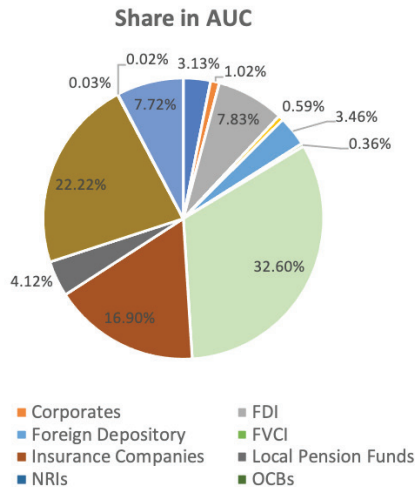
- As they do not have a banking licence, non-bank custodians cannot offer transactional services that complement custodian services such as deposit accounts and foreign exchange management. For these transactional services or forex services, the non-bank custodian needs to engage the services of a regular bank.
- Thus, activities such as onboarding new clients with a bank account and payment settlements require the custodian and the client's preferred bank to exchange documents and instructions. The additional administrative work and cost hinders the ease of doing business.

India's custodian services market has seen significant development in recent years. Assets under custody (AUC) in the Indian market grew ~36 times at a CAGR of ~22 percent from FY02 to FY20. Despite this growth, India's share in the global custodian market is a mere under 2 percent, which is inconsistent with the country's global GDP share of 3.5 percent. Like-to-like basis, ignoring FDI and depository receipts, as of March 2019, FPI equity under custody was INR 29.24 lakh crore versus the aggregate equity under custody of INR 56.21 lakh crore, a 52 percent market share.¹ **Against this, about 90 percent of FPI AUC is still with foreign banks. Four MNC bank custodians, namely, Deutsche Bank, Citibank, JP Morgan and HSBC, control about 70 percent of this.**²

Foreign Portfolio Investors

Accounting for almost a third of the total AUC in India, FPIs require custodians to manage their securities and cash transactions. These investors also require a bank account for executing their capital market transactions and cross border foreign exchange transactions for settlement of securities in local currency. As these services can be provided only by full-service banks, the foreign banks are better positioned than non-bank custodians to serve FPIs. These services also provide significant additional revenue streams for full-service banks.³

Notably, non-bank custodians in India are not being appointed custodians for investment funds from the US due to SEC Rule 17 f-5 (under the Investment Company Act of 1940). Market participants interpret this rule



Source: SEBI as of 31 March 2019

as meaning that only a banking institution or a trust company is an eligible foreign custodian for US investment companies. Even the new rule 17f-7 permits a fund to maintain assets with a foreign securities depository with conditions that restrict it to only banking custodian services. First, the depository must be an “eligible securities depository”. Second, the fund’s “primary custodian” must provide the fund or its adviser with an analysis of the custodial risks arising from engaging a non-bank custodian, and notify the fund of any material change in risk associated with using such an entity. The rule defines a primary custodian (often referred to as a “global custodian”) as a US bank or qualified foreign bank (as defined by rule 17f-5) that contracts directly with the fund to provide custodial services for foreign assets.⁴

Due to these additional responsibilities imposed on the US-based “primary custodian”, Indian non-bank custodians are unable to offer custody services to any fund regulated under US SEC provisions. Specialized custodian foreign banks, too, usually only appoint full-service banks as sub-custodians in India to service their institutional clients. While the above rule applies only for investment companies (example, mutual funds), India’s non-bank custodians appear to miss out on other US-based institutional clients (such

as investment advisors) because such sub-custodian arrangements are only with MNC banks.

Domestic mutual funds and insurance companies

With a contribution of ~40 percent, asset management companies (AMCs) and insurance companies are the largest clients to Indian custodians. Unlike FPIs, domestic funds do not require foreign exchange services. Some do expect other services, such as safekeeping, credit lines (intra-day and overnight) services, and fund accounting from their custodians.

Indian non-bank custodians are unable to provide a broader suite of financial services required by custody clients (such as cash management, credit facilities, and foreign exchange services) owing to local regulatory constraints. As these restrictions limit the business opportunities available to them, some non-bank custodians have called for a specialized banking license for custody services providers in India.

Future of Indian Custodial Services

The COVID-19 pandemic has impelled governments across the world to implement stimulus packages to revive their tanking economies. This being the first time in more than six decades that an exogenous factor has triggered an economic crisis, the stimulus has been sizeable and continuous. The flush in global liquidity looking for returns has spurred FPIs across the world to invest in both equity and debt in India. Market experts expect a surge in FPIs registering for investments in India in the next two years. If so, the custody business should grow and so will the need for better services. It is also time to make this critical financial infrastructure more robust and competitive.

According to a report by Deloitte, the fee income of core custodian services, including safekeeping, transactions settlement, and asset servicing, contributes ~40 percent of the total revenue of specialized custodian banks. The next key contributor to revenue, estimated at 20 percent, is Net Interest Income (NII), largely derived through interest income generated by specialized custodian banks against clients cash deposits (through reinvestment and extension of credit to clients for operational purposes). India's relatively higher interest rates than mature economies, the share of NII is expected to be much higher.⁵

For a limited set of specialized custodian banks, the prevailing interest rates in India were applied (on both assets and liabilities) and the resultant share of NII was determined at ~35 percent by Deloitte. The balance revenue share for specialized custodian banks is earned through forex services (~5%) and other additional services, such as issuer services, investment management, securities lending, and treasury services.

Similar to specialized custodian banks, Indian non-bank custodians specialize in custody-related services; unlike specialized custodian banks, a typical non-bank custodian in India does not have access to revenue streams such as NII (~35 percent) and forex services (~5 percent). According to industry sources, Indian non-bank custodians do not have access to about 65% (~2/3rd) of the revenue opportunities that are available to specialized custodian banks.

This framework decidedly limits the scope of non-bank custodians to succeed on their own, since they have to divide income with other banks to provide forex and other banking services. In 2017, the Global Custodian-India Domestic Survey ranked Stockholding Corporation of India, Orbis, and Edelweiss as India's top three custodian service providers⁶. This implies that local knowledge plays a significant role in the market.

Policy and regulatory challenges in India

Even after 30 years of liberalization, the custody of foreign investments (FPI) is controlled and monopolized by foreign bank custodians. This is not due to any shortcomings of custodians but because of India's restrictive banking regulations--a strange anomaly created and perpetrated by India's regulators.

Due to the absence of specialized custodian banks, India does not have any Indian custodian that has been appointed as a sub-custodians by any global custodian (BNY Mellon, State Street, BBH, and others).

Large US-domiciled fund houses wish to shift to Indian custodian service providers but the dialogue hits a roadblock when it comes to approving their local banking partner. Their misgivings are based on the high NPAs of Indian public sector banks (PSBs) compared with the exposure of foreign banks to NPAs the world over. **Due to their risk aversion with PSBs for banking support, they do continue with foreign banks providing custodian services along with forex management services and other services.**

Though custodian banking is the safest banking model and is universally adopted the world over, India continues to be non-committal on the issue of its implementation. This is after six years of first round of differentiated or specialized banking being introduced.

Custodian banks provide specialized banking services in compliance with RBI-stipulated prudential norms. They provide services such as fund accounting that are sought by global clients and not offered by domestic banks. Non-bank custodians can offer critical business intelligence tools that even MNC bank custodians are not providing currently.

Given the prevalent US regulations, institutions such as SHCIL, SBI, SG, and Edelweiss are not even eligible for appointment as sub-custodians to US investment companies.

The US SEC under Rule 17f-5 places restrictions on the eligibility of custodians in overseas jurisdictions. The rules clearly state that only banking institutions or trust companies are eligible foreign custodians for US investment companies.

Specialized Custodian Banking Licenses

Due to prevalent regulatory realities, the current market structure has several anomalies that create unfair competition between domestic and foreign players in custodian services. These anomalies have to be removed so that a more efficient structure benefits both the capital markets and global investors.

Non-bank custodians tend to lose business to foreign banks due to regulations preventing them from becoming banks. They are also unable to offer their services to FPIs in countries that require securities to be handled by only banking entities.

Institutional investors depend on custodians to administer their USD 220 trillion in cross-border resources, to follow portfolio streams, to localize venture pay, and to foreign exchange protections and monetary standards. A custodian seller's evaluation procedure relies on exchanges being arranged or dealt with through standing guidance. Customers look for low spreads; rivalry forces vendors to keep the spread as close to the minimum expense of arranging the transaction.

Regression analysis affirms that a custodian's markups are driven by managing costs, for example, inventory risk and operating expenses.⁷ Negotiated markups rise with conversion unpredictability.⁸ Likewise larger exchanges, even though of modest size, permit those exchanges to cover a custodian's fixed expenses.

Negotiated markups are higher for monetary standards exchanged through a sub-custodian in line with the high regulatory expenses of trade compliances and controls⁹. Since Indian custodians are mired in administrative difficulties that significantly raise the transaction cost, Indian custodians charge extremely high fees for processing transactions from investors. This makes the Indian custodians uncompetitive in the global market. Strengthening domestic custodians (or sub-custodians) by way of easing administrative hurdles would raise the market share for Indian custodial banks.

Advantages of custodian licenses in India

The provision of licenses has many advantages for India. These include:

Integrated services

Custodian banks could offer cash management and foreign exchange transaction services and evolve into integrated service providers servicing multiple customer segments.

Easing entry of investors

A few jurisdictions do not permit foreign institutional investors registered in that country to maintain securities with custodians that do not have banking licenses. Removing this regulatory hurdle potentially enables larger investment flows into India.

Level playing field

Global bank custodians have an advantage in attracting FPIs due to their banking status. Encouraging domestic custodian banks increases specialization in these services and adoption of best practices.

Encourage all types of foreign portfolio investors

SEBI's FPI Regulations, 2014, enabled Category III investors to invest in India. Category III investors mostly comprise small corporates, family offices, and individuals, among others. They generally are not the "target segment" of global bank custodians, but could be a potential target audience with specialized custodian banks optimizing enhanced inflows into India.

Making domestic players more attractive for tie-ups

Global custodian banks such as Bank of New York, State Street Bank, and others do not have an India presence and mostly use foreign universal bank custodians as their sub-custodians. If domestic custodian bank services are enabled, global custodians may consider tie-ups leading to better linkages with global capital flows.

Increasing market efficiency

Currently, non-bank custodians in India maintain multiple banking relationships. Administering multiple banking relationships funds from various sources with daily multi-client and multi-bank transactions leads to enormous administrative work, weaker STP, and enhanced costs. These extra steps can be eliminated.

Reducing and streamlining AML and KYC documentation

The introduction of custodian banks will reduce paper work as documents will be required only by a single entity rather than by both the non-bank custodians and the universal bank client transaction accounts.

New opportunities

As RBI allows Indian investors to invest abroad, some Indian mutual funds have, indeed, availed of the opportunity. Custodian banks can meet the requirements of such mutual funds through tie-ups with overseas providers of custodial and banking services.

Impact on NRIs investments

Foreign investors are a key source of investment for India contributing USD 8,627 million to the Indian economy in 2019-20 according to RBI.¹⁰ Currently, NRI investment is included in the FPI investment flows. The presence of custodian banks that offer specialized services such as asset protection, transaction and other financial instruments, will encourage further investment from NRIs.

Addressing restrictive trade practice

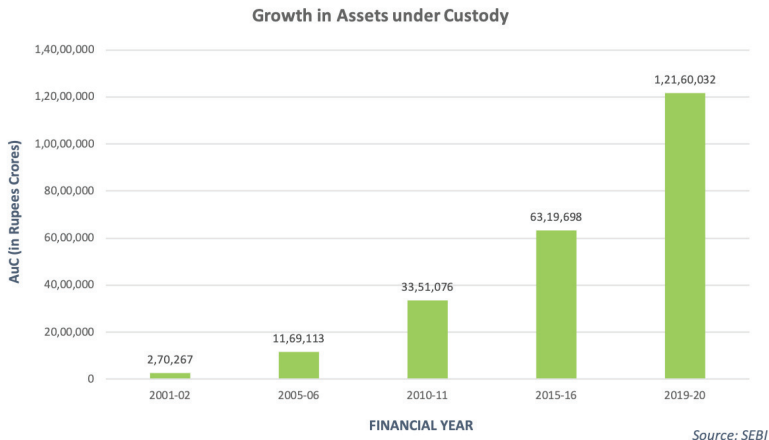
Practices such as the US SEC 17f-5 and 17f-7 do not permit Indian custodians to provide services to American investors because Indian custodians are primarily non-bank custodians. Thus, Indian custodians lose out on American investments at the cost of foreign banks. The presence of specialized custodian institutes overcomes this rule and allows Indian custodians to also reap benefits from American investment into this billion-dollar business and national forex-earning opportunity.

Custodians' Impact on Indian Market and Economy

Custodian banks, as discussed in the beginning, are specialized differentiated banks and focused custodian services providers. Their clients include FPIs, mutual funds, insurance, pension funds, and banks channelizing FDI flows into India. Custody and settlement practices vary from country to country, therefore FPI investors often engage with local custodian banks if the regulations permit. A report suggests that advanced economies possess more custodian banks than their less-developed counterparts¹¹.

The global custodian market is currently valued at USD 270 trillion¹². The Custody Service Global Market Report suggests North America was the largest region in the custodian services market in 2019. Asia-Pacific is expected to be the fastest-growing region in the forecast period¹³.

The Indian custodian services market has grown significantly in the past two decades between 2000 and 2020. The AUC for the Indian market increased ~36 times at a CAGR of ~22 percent from FY02 to FY20 but India's share in the total global custody market is still less than 2 percent. Compare this with India's share in global GDP, at 3.5 percent. Evidently, the country's AUC market has significant room to grow. As the Indian capital market matures and attracts investments, its share in the global custody market is expected to significantly increase. FPIs (28 percent), mutual funds (21 percent), and insurance companies (17 percent) are the main client segments for custody services, and contribute more than 65 percent to the total Indian AUC.

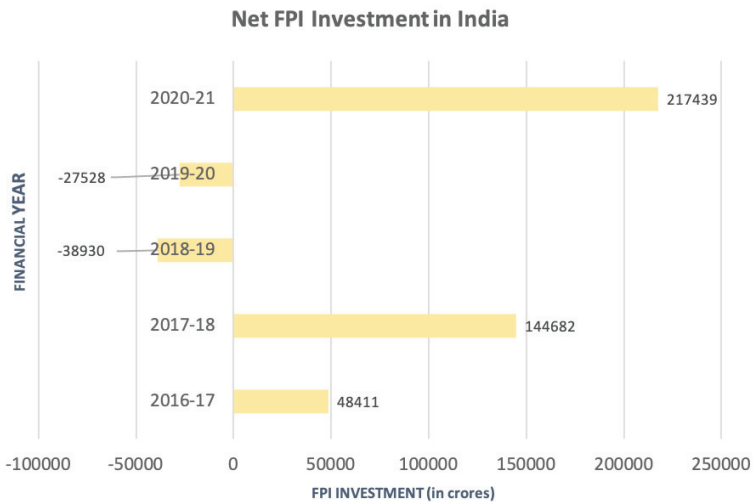


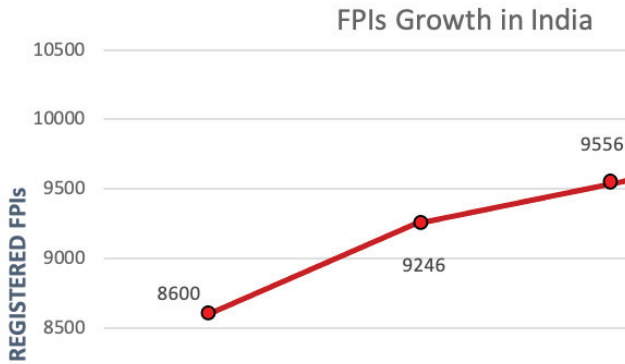
Competition in the Indian market has kept custody revenue levels low. Moreover, custodian services are seen as commoditized services. While specialized custodian banks are estimated to earn an annual core revenue of ~0.016 percent of their AUC in international markets, non-bank custodians in India earn ~0.011 percent in revenue. This may mean that Indian non-bank custodians earn about 75 percent (3/4th) of the fees earned by global custodians for comparable core business.

Foreign portfolio investment servicing

In January 2018, SEBI introduced an FPI categorization for investment in India. This move merged the previous FII, sub-accounts, and qualified investors into a single category. NRI flows are proposed to be included under FPI regulations, although this hasn't been operationalized.

A BNP Paribas report suggests that the recent reform in India spawned more than 1,000 new FPI registrations in 14 months.¹⁴ As of 2020, 10,479 FPIs are registered in India, according to CDSL¹⁵. The increase is due to process simplification and increased speed of registering FPIs. SEBI-appointed designated depository participants (DDPs or custodians) have the mandate for registering FPIs efficiently.





Investors must follow a five-step process to take the FPI route:

1. Obtain tax registrations
2. Register as a Foreign Portfolio Investor
3. Open a bank account in India
4. Open custody and depository accounts
5. Open a trading account with broker
6. Start investing

The above process is routed through registered DDPs, that is, local custodians. Currently, India has 16 DDPs compared with 19 custodians¹⁶. The FPIs are further divided into three categories depending on risk.¹⁷

Category	Category I	Category II	Category III
Criteria	<ul style="list-style-type: none"> - Govt and gov-related foreign investors - intl./multilateral org/agencies 	<ul style="list-style-type: none"> -Appropriately regulated institutions/persons/ broad based funds -Non-appropriately regulated broad-based funds whose investment manager is appropriately regulated; -University funds and pension funds; -University related endowments already registered with SEBI as FII/sub- accounts 	<p>All other FPIs not eligible to be included in Category I & II such as trusts, family offices, individuals, corporate bodies</p>

Various custodians in India offer several services for FPIs. These include registration services, unique banking transaction solutions, structuring and tax solutions, custodial services, asset servicing, fund accounting solutions, clearing services for derivatives, customized reporting, and access to international markets.

Custodians in GIFT City

In 2015, the Indian government set up the International Financial Service Centre (IFSC) at Gujarat International Fin-Tec City (GIFT City) to develop the potential for servicing overseas finances. It is an integrated development centre on 886 acres of land with a plan for 62 million sq ft of built-up area consisting of commercial space spread over 67 percent, residential space of 22 percent, and social space of 11 percent. A conducive multi-service SEZ spread over 261 acres and an exclusive Domestic Tariff Area (DTA) spread over an additional 625 acres also forms GIFT City.¹⁸

In a recent report published by the Global Financial Centres Index, in London, GIFT City is ranked third among 15 centers that are likely to grow in significance over the next few years.

Financial services have a huge potential for growth--a dedicated hub will contribute significantly to advancing this sector. In 2015, the financial sector provided 5 million jobs and 5 percent of the GDP. Plans to increase the GDP contribution of financial markets to 15 percent of the GDP and employment to 11 million have been laid down. The contribution of capital markets and trading services has also increased considerably in the past fifteen years. The GDP contribution rose from 1 percent to 10 percent and market capitalization from USD 7 billion to USD 75 billion between 2007 and 2020.¹⁹

An IFSC caters to customers outside the jurisdiction of the domestic economy. It deals with the flow of finance and financial products and services across borders. IFSC, as envisaged in the Indian context, "is a jurisdiction that provides financial services to non-residents and residents (institutions), in any currency other than Indian Rupee (INR)". IFSC's mandate is to undertake financial services transactions that are currently carried on outside India by overseas financial institutions and overseas branches/subsidiaries of Indian financial institutions.

The use of custodians within such a framework can help streamline investments in the country. Currently, SHCIL and Axis Bank have obtained licenses for offering services in GIFT City.

Appendix

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