Personal Finance Strategies

By Philip Braude

Custodial Risk and need for guaranteed investment accounts

Custodial Risk is the risk associated with the financial institution that is holding one's investment portfolio. It is not the risk that an investment might lose value or not perform, but the risk that the financial institution might incur a fraud or go insolvent, and not be able to repay the account holder the value of the investment account. Since the recent head-line grabbing events of Northern Rock in the UK and Bear Sterns in the US, the need for investor protection has been in the forefront of investors minds. Now many investors are pondering what was once unthinkable and wondering is their savings and investments are safe.

When asked by clients about this topic, I suggest the need for the investment account to be backed by a government regulated guarantee arrangement. This is easier said than done, as to the best of my knowledge, no Israeli financial institution carries such a government regulated guarantee arrangement. I will illustrate 2 international government regulated guarantee arrangements which I suggest investors should be aware of.

In the United States, assets held in accounts offered by brokerage firms are safe, if they are covered by SIPC insurance. In the event of a financial crisis, an organization known as the Securities Investor Protection Corp. (SIPC) will step in to make sure that customer accounts are transferred to a financially sound institution. For example, that is what happened when Cincinnati based Donahue Securities collapsed in 2001. SIPC also steps in to cover losses when assets disappear due to wrongful conduct, such as misappropriation by the broke. In that case SIPC covers losses up to $500,000 per account. (Only $100,000 may be in cash). Many US brokerage firms carry excess coverage for losses above this amount.

Another arrangement is that offered to investors using policies issued by Life Companies that are based in the Isle Of Man and who are governed by their Policy Protection Act. The Isle of Man Policyholder Protection Scheme provides for the payout of 90% of intended benefits in the event that a Company is in default. Today, these companies offer sophisticated open-architecture investment platforms, which enable the investor to personalize his investment portfolio, and invest into any listed share, regulated mutual fund and even into corporate bank deposits.

I would welcome the day that Israeli based investors were offered the same protection as described above, and not have to hope that they would be rescued should their financial institution face an uncertain future, as has been very vividly demonstrated by the Northern Rock and Bear Sterns debacles. Sadly, the notion of big investment firms failing no longer seems like alarmist fantasy.

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