Making your custodian

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This article describes how custody is not a risk-less activity and is critical to the proper functioning of a pension scheme. Although custody is of great importance to the safety of invested assets, many trustees and scheme officers do not fully understand the role of the custodian and the related risks that their scheme may be exposed to. Those schemes that actively engage with their custodians, including the regular monitoring of their performance and costs, typically enjoy better value for money and are exposed to less operational risk than their peers.

The importance of a scheme's custody arrangements

Although the safety and security of invested assets is a regulatory requirement [1], and is also one of the most important responsibilities of a pension scheme's officers and trustees, many do not fully understand the role of the custodian bank and its part in the settlement and safekeeping of a scheme's invested assets. Many more do not fully understand the potential risks that their scheme may be exposed to or the reliance that their scheme has on the proper functioning of the custodian and its counterparties, including sub-custodians [2], central securities depositories [3] (CSD) and central counterparty clearing houses [4] (CCP).

Custody and other related asset servicing functions are often considered to be low priority 'back-office' activities that are typically handled by a small number of large international banks. Accordingly, custody and asset servicing are frequently assumed to be low risk and low cost activities that can be left to junior staff. However, custody is not a riskless activity; mistakes can happen and custodians' clients can lose money. The Madoff and similar scandals has also brought the whole subject of custody and asset safety into focus and an increasing number of schemes are now starting to examine these issues – issues that rarely troubled them prior to 2008.

One major UK corporate pension fund recently stated, at a conference in London at the end of 2010, that the insolvency of its custodian was the third highest risk in its list of risk exposures (although the probability of this occurring was considered low, if it did occur its impact would be substantial). Institutional investors are also starting to examine the structure of pooled funds more closely and are increasingly concerned about the lack of transparency down to the actual holding of investments where they are held in "wrappers" such as insurance policies.

It is also interesting to note that schemes that use the same custodian often receive vastly different levels of service to their peers. These service levels can result in one scheme having a different operational risk profile than that of another, even though both use the same custodian bank. Schemes that proactively manage and monitor the relationship with their custodians typically obtain higher service levels, lower fees and are exposed to less risk. Consequently, they receive better value for money overall.

The cost of custody is rarely cited as a major issue. This is because, compared to the overall cost of investment management, the cost of core custody is substantially lower. However, this can be misleading as there are other costs, including the costs of value added services (e.g. accounting, performance measurement, compliance monitoring, securities lending and foreign exchange) that are more difficult to measure or benchmark and are likely to significantly increase the total costs of custody. However, given the symbiotic relationship between a scheme and its custodian, the amount of work involved in transitioning from one custodian to another and the low priority often given to custody, schemes can be reluctant to challenge their custodians about fees or push too hard for higher service levels.

Custody – a brief overview

Global custody is a relatively new activity and only really 'came of age' in the late 1970s and early 1980s following the internationalisation of investment activity. This was accompanied by the need of investors to find a safe way of processing and recording their ownership of investments in foreign markets where the physical holding of securities was impractical or impossible. Today, the global custody market is dominated by a comparatively small number of banks with the largest, Bank of New York Mellon, being responsible for almost ten times the value of investments as that of the tenth placed bank.

[1] Section 249A of the Pensions Act 2004 requires schemes to have adequate internal control mechanisms in place. The Pension Regulator's Code of Practice repeats this requirement for a system of internal controls and requires "arrangements and procedures to be followed for the safe custody and security of the assets of the scheme".

[2] Many of the large international custodians have limited international operations and rely on networks of third party banks (often referred to as 'sub-custodians' or 'agent banks') that are responsible for the safekeeping and processing of investments in local markets.

[3] A Central Securities Depository (CSD) is an organisation holding securities either in certificated or uncertificated (dematerialised) form, to enable book entry transfer of securities. The physical securities may be immobilised by the depository, or securities may be dematerialised (so that they exist only as electronic records)

[4] A Central Counterparty Clearing House (CCP) is an organisation that helps facilitate trading done in European derivatives and equities markets. These clearing houses are often operated by the major banks in the country. The CCP's primary task is to provide efficiency and stability to the markets that they operate in

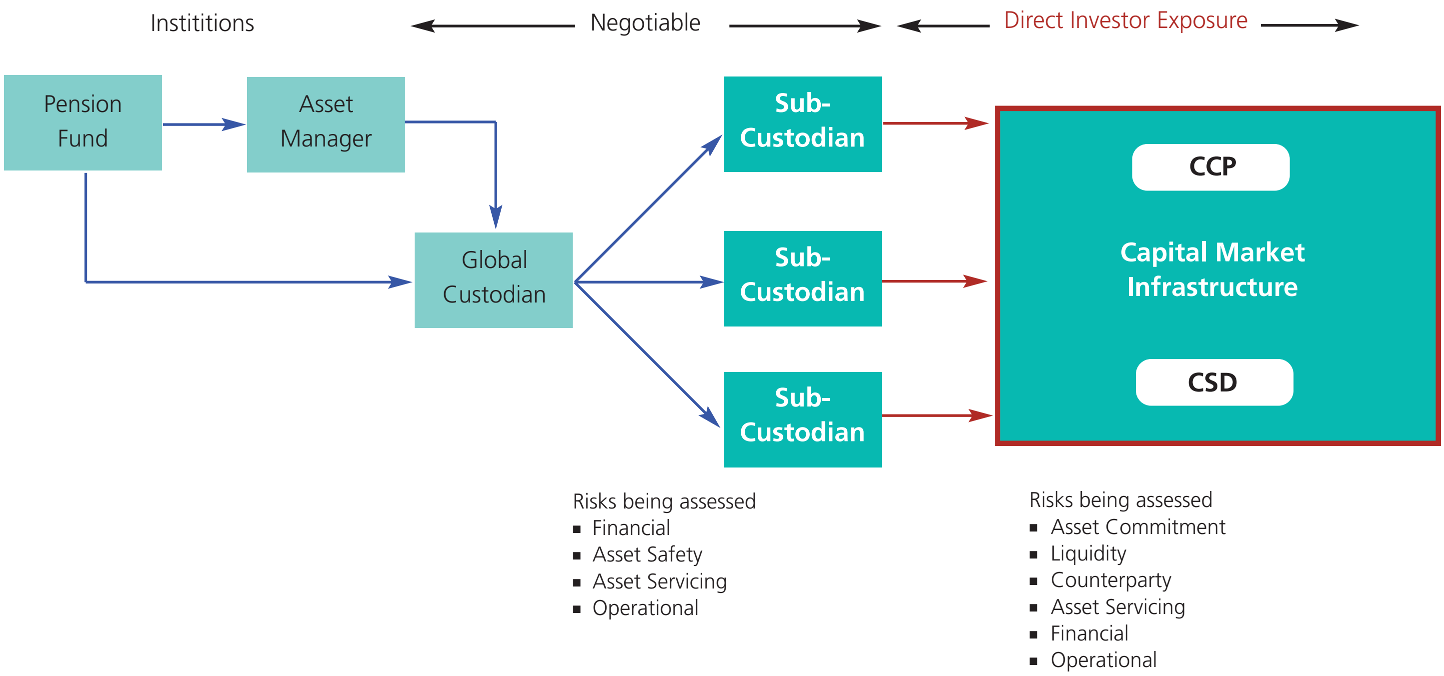
work more effectively

Since the globalisation of financial markets, custodians play an increasingly vital role in the processing and safekeeping of invested assets. It is through the custodian that all trade instructions (instructions associated with the buying and selling of securities) flow. The global custodian is also responsible for ensuring that international investments are properly recorded, processed and held safely in the local market as comparatively few securities are now held in physical form. Investors rely on electronic trading by their fund managers and brokers and the recording of investments in the books of their custodians, sub-custodians, CSDs and CCPs in the markets in which they invest. Functions such as income collection and corporate action processing often rely on the efficiency of other third parties as well as the investor's own appointed custodian.

The diagram below provides a summary of the parties involved and highlights where risks reside and where risks can be negotiated.

In addition to its role in the safekeeping of a scheme's invested assets, the relationship that the custodian has with a scheme's investment managers is important to the efficient processing of trades and the reduction of operational risks. It is therefore vital that a scheme's officers and trustees ensure that they select a global custodian that is able to service the scheme's current and future operating needs and can operate effectively on a continuing basis on its behalf. Periodic monitoring of the risks, costs and operational performance of a scheme's custody arrangements is therefore important, although many do not do this systematically or in depth.

The remainder of this article provides some suggestions that will help schemes ensure that custody and related costs are competitive and that operational performance does not expose them to unnecessary risks. ▶



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How to get the best out of your custodian

Regular dialogue with the custodian, occasional benchmarking of fees and periodic monitoring of the relationship are essential if a scheme is able to minimise the risks to which it is exposed and maximise value for money. There are several practical steps that a scheme's officers and trustees can take to achieve these goals:

- *Regular dialogue* – meetings with the custodian should be scheduled periodically and key performance indicators (KPIs) discussed. Those schemes that proactively manage their relationship with their custodian frequently achieve higher service levels and, as a consequence, are usually exposed to less risk and receive better value for money. It is important that the dialogue is at all levels and that a scheme's senior management team engages with the custodian's senior personnel to discuss possible changes in investment strategy, for example, and its implications for the future requirements of the scheme.
- *Review operating model periodically* – schemes should ensure that the current operating model (the way in which the various parties providing services to the scheme interact) is appropriate for current and future needs. Are all providers the most appropriate given the current and future investment portfolio? Would it make sense to outsource certain functions that are currently performed in-house? Can certain outsourced services be consolidated under one provider? Does the current operating model expose the scheme to unnecessary risks? Are there conflicts of interest in the current operating model?
- *Monitor performance* - most major custodians provide their clients with comprehensive data and analysis of KPIs such as failed trades, timeliness of corporate actions, income collection etc. Deterioration in any of the KPIs might indicate deterioration in the custodian's performance or the scheme's investment managers and may expose it to unnecessary risks.
- *Periodically review contractual terms* – it is not uncommon for the global custody agreement between a pension scheme and its custodian to be several years old. Often the agreement does not reflect current market practice. In Thomas Murray's experience, over 70% of contracts reviewed contained weaknesses that exposed a scheme to unnecessary operational risks.
- *Monitor and benchmark costs* - Thomas Murray's research found that in a sample of schemes, approximately 70% were paying more than they need for custody and custody related services, particularly those funds that had not formally reviewed these arrangements for several years. On average, where potential savings were identified, these represented 25% of total fees.
- *Analyse hidden costs* – it is particularly difficult to measure certain "hidden costs" e.g. the costs of foreign exchange transactions. Our own proprietary foreign exchange analytical tool can identify if a scheme has paid a premium and help it take steps to reduce this in future. In a recent study by Thomas Murray of the cost of FX execution by six custodians, the average spread ranged from approximately five basis points to almost 20 basis points and a sample of 40 clients revealed a range from two basis points to 50 basis points. These are substantial variances that can have a significant impact on the total price of custody.
- *Understand where risks reside* – where and how assets are recorded and held is an important aspect. Many trustees fail to realise that the global custodian does not protect a pension scheme in the event of the bankruptcy of a sub-custodian or CSD. Even if invested assets are properly segregated, the failure of a sub-custodian is likely to lead to the delay in the return of invested assets and the consequential exposure to market risk. Cash held with a custodian is fungible and cannot be segregated and is therefore at risk of loss in the event of insolvency. How assets are segregated at the sub-custodians is an important aspect and may impact the liquidity of investments should a sub-custodian fail.

Conclusion

The safekeeping of invested assets is one of the most important responsibilities of a scheme's trustees and officers and the relationship and contractual arrangements that a scheme has with its custodian will have a significant impact on its risk profile. Managing this relationship on a regular basis and in a systematic way is an important aspect of the management of a scheme. Frequently, schemes operate with out-of-date contractual arrangements, without any meaningful relationship with their custodians and little idea of the overall cost and efficiency of the service and how it compares to other similar schemes.

A modest investment in time and resources and some comparatively simple processes, including a review of the current operating model with the incumbent custodian, periodic review meetings and regular benchmarking of costs and performance, would help ensure that operational performance is monitored thereby reducing risk and ensuring value for money.