

Global Custodians

***'How they can help you and
how they can hinder you'***

A report by Euraplan Limited



Leaders in Fund Monitoring and Pension Accounts

INTRODUCTION

There is a general trend throughout the UK pensions industry towards making more extensive use of global custodians. Why is this so?

One of the reasons for the drift towards global custodians is that more and more pension funds have expanded their portfolios to include specialist / boutique fund managers who do not offer custodian facilities. This has obliged pension funds to employ a custodian for the specific non-custodian fund managers.

Euraplan has not as yet been able to verify whether or not there is legislation that regulates that fund managers have to have a formal separation between themselves and any internal custody service. However, OPRA has confirmed that they certainly recommend such a separation, and this has naturally encouraged further movement towards specialist custodians.

It has been a logical and pragmatic evolution from there to expand to a global custodian whose world-wide reach enables it to secure all investments and to cover all fund managers; regardless of whether they have an in-house custodian service or not. Thus a global custodian provides the pension scheme with the freedom to choose any fund manager in the future, at the same time as pulling together disparate reports from different fund managers, and providing a third party check on such reports.

What does a global custodian do?

A custodian is responsible for the safe keeping of the assets of the pension fund, and ensuring that all holdings have been registered as assets of the fund, usually by the custodian acting as the nominee of the pension fund.

A custodian manages the settlement of all the bargains entered into by the fund managers, collects all dividends and interest accruing to the fund and holds all the cash.

A global custodian (as the name implies) has the capability to perform these functions on a global basis. This is a most important facility as most funds now invest on a global basis.

This is the core custody service that a global custodian provides. It is fundamental to the well being of the pension fund. Most global custodians are large American banks with world-wide coverage, and they are experts at supplying this service.

Unfortunately for the custodians, the supply of this core function is a very competitive business, which they find difficult to perform profitably. Accordingly, they invariably attempt to “bundle” other services such as investment accounting and fund monitoring into an all-encompassing enlarged fee. Whether they are as efficient at supplying these additional services as they are at supplying their core function is the question that has to be asked.

There is certainly a case to be made that on an in-house basis it is both more secure and more cost effective to execute these additional services independently than to trust them to the global custodian.

RATIONALE FOR RETAINING INDEPENDENT IN-HOUSE CONTROLS

For those of Euraplan's clients who have engaged a global custodian but insisted on retaining their own internal controls and restricting the bank merely to the task of custody (and Euraplan have many such clients), the overriding reasons for doing so appear to be :-

Compliance and Assurance

Compliance and assurance appears to be the biggest concern. Are Trustees really carrying out their statutory duties merely by relying on a global custodian to tell them that "all is well"? Without any internal checks and balances in place how can the Trustees be assured that everything has been reconciled and proved to be correct?

This was more than just an "added comfort" to many of the funds and trustees to whom Euraplan has spoken to. A number mentioned occasions when their custodian had not only made mistakes, but more worryingly changed their computer systems, and lost data in the transition. If the pension fund had not maintained its own records it is difficult to see how the accurate position could have been re-constructed.

US Accounting Standards

Because the majority of global custodians are American banks, and because America is where global custody originated long before it came to Britain, investment accounting and fund monitoring tools are aimed primarily at the American market.

US accounting standards are not as rigorous as ours. (This opinion was expressed by a number of clients even before the Enron and Anderson debacle.) Furthermore, the systems of the global custodians (developed with these standards in mind) have proved to be somewhat inflexible when applied to British pension schemes.

In particular, some Euraplan clients have expressed a concern that within American banking circles **reconciliation** is less rigorous than within the British equivalent.

In the former an **“explanation of a difference”** rather than the actual **“correction of a mistake”** appears to be the norm. It has proved very difficult to insist on the more rigorous British approach, and it is often a challenge to even open the discussion on rectifying such differences. If the client does not pursue matters continuously, a period of silence is often taken as signifying acceptance.

Audit Trail

Maintaining independent in-house records provides an audit trail that satisfies the auditors. A comprehensive and independent audit trail should be a negotiating point, when discussing next year’s audit fee, i.e. leading to a reduced fee.

In at least two cases that have come to Euraplan’s attention, such records also allowed Euraplan clients to quickly and efficiently produce important historic information for a prospectus to be published prior to the merger of the sponsoring company.

They did not believe that their global custodian would have had either the flexibility or the capability to produce this information within the required time scale.

‘All the eggs in one basket’ and ‘a small fish in a very big pond’

The clients with whom Euraplan have researched these comments (i.e. those who have gone to global custodians for custody but retained their own independent monitoring of investments) have highlighted the “all the eggs in one basket” syndrome as something about which Trustees felt particularly uncomfortable.

This is especially important in today’s environment when The Myners Report recommends (and the Government threatens legislation to require) that Trustees should have a clear understanding of

exactly where and for what their pension scheme is incurring expense. In other words “transparency”.

Clients have found it difficult to obtain a detailed breakdown of charges from their global custodian, and hence almost impossible to investigate the competitiveness of things like the foreign exchange rates being charged.

Even large pension schemes with more than £2 billion under management have complained to Euraplan how inflexible they find their global custodians, and how difficult it is to pin anyone down to actually delivering a commitment. There tends to be a “take it or leave it” attitude on the part of global custodians as opposed to any individual customer care response.

The reason for this is often due to a combination of size and history. Multinationals in all industry sectors find it difficult to be as light on their feet and as responsive as specialist, national players, where the chain of command is neither as long or as far removed from the UK.

Speed of Response

Because these American banks have been in this business in the USA for many years before global custody even became a topic here, their IT systems tend to be large main frame number crunches from the over-night batch processing era. Some have been illustrated to Euraplan as being incapable of anything other than a standard monthly cycle with standard month end valuations. This is not very helpful in a fund manager transition scenario.

Further examples of dissatisfaction that have been highlighted by Euraplan’s clients are the slow speed of settlement and recovery of overseas taxation, and the efficiency of ensuring that all dividends and interest that should have been received.

Conflict of interest versus ‘Chinese Walls’

Some global custodians are also fund managers. As consolidation continues across the world within the financial sector this is likely to occur more often. Obviously “Chinese Walls” are erected, but there are so many examples throughout business of self-policing not working, that this is a matter of concern for many Trustees.

Who checks the custodian?

If the answer to this is no one, then it is the same as never reconciling your cash book to your bank statements.

If your commercial bank has made an error, then unless you do a regular reconciliation, you will never know about it and never be in a position to demand a correction.

UK commercial banks have the biggest computer centres in the land, but mistakes do occur. It is for this reason that every company in the country (and indeed every pension fund) regularly reconcile their internal cash records to their bank account.

Why should the same prudence not be applied to the large American bank that acts as your global custodian? Mistakes will occur within their vast computer systems in exactly the same manner that they do for the UK commercial banks.

Furthermore, the bank who acts as your global custodian is not only going to hold all your assets throughout the world, it is also going to manage the flow of all your money with your investment managers and ensure that nothing gets lost or delayed along the way.

How are you going to check this?

Most pension funds do not know the answer to this question. In many cases there is just blind faith that because global custodians are both large American banks and multinational corporations, they

must have their own internal controls that ensure total accuracy. This is more than a little naïve, and in real life it does not turn out to be as simple or indeed as secure as that.

What about the functions a custodian performs which are not checked by the fund managers?

There are certain functions which a global custodian undertakes for most pension schemes, which are independent of the fund manager's reports.

These include :-

Tax recoverable

Making sure that all the tax recoverable is received

Corporate Action monitoring

Making sure that all corporate actions pertaining to your scheme's holdings have been processed correctly and in a timely manner.

Foreign Exchange best execution

Ensuring that your custodian is using the best foreign exchange rate when converting your currencies.

Cash management

Ensuring that your custodian or cash manager is calculating interest correctly, including backdated interest adjustments, and monitoring the rates of deposits you receive from the relevant party.

Euraplan's investment monitoring software checks the above functions and allows you to pin point exactly where mistakes are being made. The software solutions allow you to monitor these activities quickly and accurately. Euraplan have automated computer feeds with over 40 fund managers and custodians across the world and continue to develop more and more of these links.

HOW EURAPLAN'S 'SHAREHOLDER' SOFTWARE ENABLES YOU TO MAINTAIN IN-HOUSE INDEPENDENT CONTROLS

Euraplan has been working with UK pension funds for the past 16 years. Euraplan was specialising in the niche UK market before the global custodians even thought about coming over from America. Euraplan's fund monitoring software 'Shareholder' has been designed specifically for (and usually in conjunction with) UK pension schemes. Today Euraplan have over 140 users of its software.

Euraplan's investment monitoring systems can supply you with summary, or detailed information, to back up the controls you have set your global custodian. It allows you to reconcile between managers and your fund managers and custodian using independent information, therefore ensuring that your custodian is doing the job properly and providing you with the best possible service.

Euraplan's software also allows you to retain a history of investment activity over many years. This internal database is used by Euraplan's clients' auditors as an audit trail and a back up to the figures used in their accounts.

Once the user feeds in the trades and corporate actions for one month, the systems will check realised profit and loss and book cost calculation. By downloading the independent income, market prices and foreign exchange feed from FT Information, you can monitor income due but not received, the market value, and currency gain & losses and corporate actions which have not been processed. Finally, the system produces the figures to be slotted into your accounting system. The latter can be done through an automatic download or manually. This is a simple explanation of the basic functionality of Euraplan's investment monitoring system

It facilitates the design of client specific reports as well as providing multiple standard reports. Thus it allows you to run off the required reports whenever necessary, and not at the behest of a multinational supplier.

Additional Services

Euraplan's software also facilitates additional services such as Transaction Cost Analysis, providing a detailed report of both implicit and explicit transaction costs.

SUMMARY

The viewpoint of a number of Euraplan's long-term clients

When the Goode Committee issued its post Maxwell report, a number of Euraplan's established customers were relieved that the recommendations did not require the appointment of some form of external "custodian". This was because they already kept comprehensive records in-house, and wanted to continue to do so.

At that point in history fund managers were also providing their own internal custody service "for free", so there was no requirement to employ an independent custodian of any description.

However, as discussed in the introduction, that began to change a few years ago with more and more fund managers declining to offer their own custody service.

The logical and practical solution is to appoint not merely a custodian, but a global custodian, and more and more pension funds are doing exactly this.

But again as discussed, basic custody is not necessarily a lucrative business, and global custodians accordingly seek additional sources of income by offering associated services. The question the pension fund has to answer, therefore, is whether it wants just the basic custody service, or whether it also wants to buy the other offerings.

Some of Euraplan's clients who have elected to purchase just the custody service, also point out that whereas the global custodians are uniquely capable of supplying this specialisation, custody itself is a most boring and intellectually unsatisfying occupation. Accordingly, ambitious, bright people tend to move on. *The global custodian is thus good at custody, but not necessarily good at anything else.*

Because of the enormous databases created by carrying out the custody function, they can produce data. But can they interpret it? Data only becomes valuable when it is converted into information. The key is the interpretation.

In the view of the clients Euraplan have spoken to, it is always best to get data from someone who specialises in that specific data and can therefore add value to it. In other words, you should get your investment data for performance measurement direct from the fund managers whose specialisation it is, and not from someone who has accumulated it as a bi-product of his or her core task.

If you want an analysis of your transaction costs or an assessment of what you are paying for foreign exchange, you should acquire the data from the most independent source and seek the most specialised interpretation of it.

The clients who supplied Euraplan with this opinion do exactly this by using Euraplan's software Shareholder and also OpenAIR Investments to reconcile their investments and associated costs.

Size of Pension Fund

During Euraplan's investigation to find out client opinion of the best use of global custodians, the organisation ascertained that as necessary as global custody has become, it is really quite difficult for small to medium pension funds to obtain commercially viable quotations.

This appears to be because various global custodians are reluctant to deal below a certain financial ceiling (£1 billion has been mentioned) and if they do quote for funds below this figure they only quote a "bundle price" that automatically includes all their (more lucrative) additional services.

The advice that established users of custody-only services have passed to ourselves is that pension funds should always insist on separate quotes for both the basic custody service and the

additional accounting services, and that custody should not be more than (say) 10 basis points or 1% of the funds under management.

SUMMARY

Euraplan's viewpoint

While the industry move towards global custodians over recent years is necessary, beneficial and easy to appreciate; there is now a similar move occurring, post Myners, towards “transparency” and “accountability”.

Many Boards of Trustees are coming to the conclusion that they cannot truly carry out their ethical and legal responsibilities on behalf of the beneficiaries merely by accepting what they are told by a contractor - whether that contractor is a bank, a fund manager or a global custodian. They want their pension scheme to have an in-house ability to ensure that the information it receives from its various agents is correct.

Do the assets held by the custodian reconcile to the transactions carried out by the fund manager? Has all the income been accounted for? And in this context “to reconcile” means to the penny, and not just to a percentage or a “margin of error” allowance.

Trustees recognise that they have to delegate certain functions to specialists, and to take expert advice from others. But they are guarded against delegation becoming abdication. And they are anxious to ensure that they have ways of cross-checking and balancing the expert advice that they are obliged to depend upon.

Other Trustees may consider this an unnecessary “belt and braces” approach. But Euraplan have certainly witnessed within Euraplan's client base of some 140 pension funds, a heightened appreciation by the Trustees of their responsibilities, brought about by the enhanced publicity that Myners, deficits, the demise of final salary, and FRS17 have attracted in the press. This has led to a corresponding awareness of the controls that they need to have exercised on their behalves, so that they can categorically say they have exercised all due diligence in the execution of their trusteeship.

FURTHER INFORMATION

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