

Monitoring the relationship

By Simon Murray

Jun 1998

There is growing acceptance in the pension fund industry that fund assets are exposed to custody risks as well as investment risks. Asset managers and actuarial consultants have a wealth of experience in setting investment objectives and risk parameters, and assessing performance against various industry benchmarks. These groups are often not as well equipped to carry out a similar role in assessing custody performance and risk.

The recent financial crisis in the Far East is only one of a series of near-miss custody disasters. The answer to questions such as "is our money always safe and recoverable when invested in foreign markets?" and "are we liable for any losses arising out of our custodian's activities?" may surprise and alarm some pension fund trustees.

Pension fund assets are not always recoverable in the event of bankruptcy, fraud or (say) systems failures in all markets, and pension funds may be directly liable for custody losses in certain operational areas.

The Barings collapse highlighted the difference between a pension fund's exposure to loss of cash and its exposure to loss of securities. Cash held by custodians, their agents or counterparties cannot easily be ring-fenced or segregated. Securities, on the other hand, can be protected. The emphasis is on 'can be' because securities are not always properly ring-fenced and, even where they are, they may not be immediately recoverable if a custodian fails.

Since Barings, pension fund trustees have been more careful to define cash and safekeeping/registration policies. However, our experience is that many funds still do not know all the right questions to ask their asset managers or their custodians.

One of the main difficulties in assessing custody risk is that clearing, settlement and safekeeping practices vary widely around the world. Progress towards establishing common standards has been slow, even in basic services. Countries also have different legal systems, not all of which conform to the Anglo-Saxon trust concept so vital to the process of establishing property rights over assets.

Faced with the diversity and complexity of local market practices, asset managers and custodians have adopted different safekeeping practices, both at a global and local level. In some markets, for example, custodians have a choice of where to hold securities, and how to hold them.

In addition to safekeeping risks, pension funds may also be exposed to losses arising out of the servicing of assets. This includes losses arising from failed trades, missed income entitlements, failure to respond to corporate actions, or incorrect valuations. Losses in these areas can run to millions of pounds.

In the past, asset managers and custodians tended to cover up custody related losses, especially those caused by their own mistakes, or problems with agent banks in foreign markets. Senior executives within asset managers are now becoming acutely aware of the potential scale of custody risks in global investment. Indeed, they are being driven to recognise and take legal responsibility for these risks by their own clients.

The asset managers' commercial response has been to outsource as much risk as possible to custodial banks. The custodians may take responsibility for some losses, but in practice, custody contracts may be written heavily in the custodian's favour. Worse still, the custody contract may be silent on responsibilities for important areas of risk.

Alongside the contractual positions, pension funds should monitor their custodians' performance, and in particular the way custodians make money from cash and foreign exchange deals relating to settlement activities and the provision of basic services. Some of these services, such as contractual settlement and contractual income, benefit both custodians and clients. There may be hidden costs to clients (for instance, in delaying payments), but at least clients have more predictable cash flows.

Other cash and foreign exchange services provided by custodians may simply be uncompetitive. Asset managers are generally very disciplined when selecting and monitoring counterparties for cash and foreign exchange deals. However, when it comes to using custodians, asset managers sometimes forget basic principles. Custodians have considerable amounts of securities-related cash and foreign exchange passing through their books. Their costs and rates should be monitored just as closely as with any other counterparty.

All pension fund trustees must establish a clear set of custody objectives and risk parameters, to cover asset safety and risk positions, quality of service (such as contractual settlement services) and value for money (such as cash/FX rates). The process of establishing the right standards takes time, and normally requires commercial as well as legal advice. It is a small price to pay, relative to the potential and actual losses inherent in custody activities.

The extent to which each pension fund formally measures its custodian's performance against the standards set depends on the nature of the custody arrangements. Where a pension fund invests in a pooled vehicle, then the pension scheme has to rely on the custodian(s) appointed by the asset manager/trustee. It is important to review this arrangement, but there are few practical ways of changing the situation, other than switching to another pooled fund.

Where a pension fund has a segregated fund, and relies on the asset manager's chosen custodian, the asset manager should monitor the custodian's performance. Clients will seldom need to become involved. However, they must read the 'small print' in the asset management contracts. Who is contractually responsible for risk? What steps does the asset manager take to minimise risk? How does the asset manager monitor service quality and costs? If the answers are unclear or unacceptable, it is time to renegotiate the contract, or appoint an independent custodian.

Finally, where a pension fund appoints an independent custodian, it must take responsibility for reviewing the custodian. This is not as onerous as it sounds, as long as proper legal and service level documents have been agreed, and the custodian (plus asset managers) are able to produce performance assessment reports.

Simon Murray is director of Thomas Murray in London"