



## Agents of change

**OFTEN DAMNED AND RARELY PRAISED, CONSULTANTS PLAY A KEY ROLE IN THE CUSTODY SELECTION PROCESS.**

**JANET DU CHENNE REPORTS**

As the topic of custody and back office outsourcing seeps into more fund manager boardroom meetings, the use of custody consulting services becomes more commonplace. When faced with the challenge of potentially costly and time consuming outsourcing projects, institutional investors such as pension funds, fund managers and insurance companies usually seek the expertise of specialist consultants.

The extent to which custody consultancy services are sought depends on the type of client. While traditional and local authority pension funds normally use an actuarial consultant for custody advice, fund managers and insurance companies hire specialist consultants to advise their custodian selection process.

"There has been an increase in the use of independent consulting services among corporate and local authority pension funds," says Penelope Biggs, senior vice president of corporate and institutional services at Northern Trust. "These clients are often not sufficiently familiar with all the nuances of global asset servicing to make decisions of this nature in isolation and value the help of a consultant to guide them."

With the recent sharp decrease in assets triggering alarming pension fund deficits, the average pension fund manager or trustee does not always have much time to devote to complex back office issues. As a consequence, custody consulting services are often used to enable pension fund trustees to concentrate on their core competencies.

Apart from pension funds, many investment managers are also aiming to separate their asset management and asset servicing functions and are summoning specialist consultants to assist in the appointment of external asset servicing providers.

While reeling from the effects of rapid consolidation and diminishing asset bases, insurance companies also have more than enough issues in the front office to keep them busy over the next few years. As the European Union expands and the adoption of the Euro continues to increase, investors are placing more of their assets outside of their local remit. This trend drives a growing need for institutional investors to consolidate global assets with a global custodian. Again, specialist consultants are advising on the best service provider for the job.

As a global custodian, Northern Trust has been awarded major European mandates through specialist custody consultant Thomas Murray. AMF Pension, one of Sweden's largest pension insurance companies, hired Thomas Murray to assist in its search for a global custodian. After a lengthy search and selection process, the fund appointed Northern Trust to provide global custody and securities lending services to its \$9bn of global assets.

Custody consultants such as Thomas Murray are becoming more involved in the various stages of the custody request for proposal (RFP) process. In a standard RFP, the custodian receives notice of the RFP from the consultant and has roughly a month to submit its response. If shortlisted, the custodian has an opportunity to present to the pension fund manager or the fund's trustees. Following this step, a further shortlist is established and a team of fund representatives will visit the shortlisted candidates to perform the necessary due diligence work.

"For the client, the use of a consultant brings added consistency and expertise to the RFP process," says Biggs. "Specialist consultants can also bring a touch of formality to the due diligence stages of the review."

During the RFP process, consultants can arrange and co-ordinate all meetings between client and potential custodian. They can also facilitate all correspondence between both parties.

Besides the client, specialist consulting services can also help the custodian. "For

the custodian, the involvement of a consultant in the custodian selection process means that the search will be coordinated in a fair and impartial manner," says Biggs.

But certain risks and problem areas may arise as consultants simply cannot be 100 per cent knowledgeable on every facet of global custody. "There is a risk of being over-reliant on the consultant," says Biggs. "That is why the best decisions are made when the client is familiar with the key issues surrounding the safety of their assets and is actively involved in the appointment process."

As institutional investors review their custodial arrangements more often nowadays than they did in the past, the use of custody consulting services looks set to grow still further.

Global consultant Mercer is largely focused on the provision of custody consulting services to UK pension funds. Apart from the UK, Mercer has a number of branches in Australia where it has helped some of the country's largest superannuation funds select custodians. "The use of custody consulting services is definitely more commonplace among pension funds," says Mark Walker, head of European custody consulting at Mercer. While the larger pension funds will employ the advice of their in-house consulting team when looking for a custodian, the majority of UK funds appreciate that custody is a specialist area and will hire a specialist consultant for advice.

Consultants can provide pension funds with access to information on literally hundreds of custodians in the industry. Companies such as Mercer can also use their global databases to minimise the length of the request for RFP process. Pension funds can find invaluable information contained in these databases.

Mercer also keeps RFPs short by making use of existing information on databases and tailoring the RFPs to the specific needs of the client.

The RFP process for fund managers is far more lengthy and complex. These clients require a lot more concise information on a custodian than a pension fund would, forcing the consultant to be very clear on the information requested.

In Walker's experience, many of the potential problem areas and risks associated with using external custody consulting services can be avoided by open communication and ongoing dialogue between custodian and client. The consultant should act as a conduit for this dialogue. "The fund management arena can be more complex and difficult owing to specific asset manager requirements as far as custody services are concerned. As consultants, we have to be extremely articulate when providing information on the service providers."

As head of the Pension Fund Partnership in the UK, Kevin Sims has first hand experience of institutional investors' increasing reliance on custody consulting services. "Clients can receive expert advice from expert people who have a broad perspective on the custody industry and its interdependence with other service and product providers," he says.

Thanks to specialist consultants, many custodians are now more aware of areas of their service offering that may need improving. "It will be clear to the custodians which areas of the industry the consultants are focussing on, driven by their clients' needs, and if they are weak in any of these areas it is in their interests to address them," says Sims.

Possible failures associated with specialist consultancy services happen when the consultant does not have an adequate grasp of the way in which a client operates.

Even worse could be the assumption by the consultant that it understands the client and tries to secure something which is not actually what they want or even need.

Good communication between the consultant and the client is key to the custodian selection process.

Leading consultant Thomas Murray has provided custody advice since 1994. Throughout the years, the company has noticed an increasing requirement for specialist consulting services as pension funds, fund managers and insurers look to consolidate their assets with one custodian. "There is a growing acceptance in the institutional investment industry that fund assets are exposed to custody risks as well as investment risks," says Joanne Parker, director of investor services at Thomas Murray.

"If groups do not have the resources or custody expertise in-house, then they would be well advised to seek the help of an independent consultant."

According to Parker, consulting services give the trustee an ideal opportunity to make the custodian aware that they are backed by specialist advice.

"Regulatory pressure in the UK, for example Myners and the Financial Services Authority's Conduct of Business Rules, have raised the profile of transparency

and more and more institutional investors and their trustees are looking for ways to demonstrate that their fee quotes, service levels and legal agreements meet best market practice," she says. "The use of specialist consultants can provide that independent view.

"Custodians will almost always prefer to have direct access to the clients. If some custodians consider consultants a necessary evil, many custodians have recognised that there can be benefits from the consultant's involvement. Reviews run by specialist consultants tend to follow a predictable work plan and custodians will know what to expect at each stage," she adds.

Nowadays, the RFP does not end where client and custodian meet.

Consultants such as Thomas Murray are able to provide a custodian rating and benchmarking service, which provides an ongoing assessment of a client's custodian. In conducting structured and objective benchmarking, investors can feel confident that they have met their client and fiduciary responsibilities, and at the same time, kept the regulators on side.

US consulting firm Watson Wyatt is also well-known among various local authority and corporate pension funds in the UK and Europe.

Historically within the UK, fund managers used to provide custody services to their pension fund clients. But, increasingly, a separation between the custody and fund management functions of the fund manager is sought.

Until recently, many pension funds appointed one custodian for each set of assets. But the subsequent introduction of multi manager investment strategies made it difficult for a single custodian to provide consolidated reporting for the pension fund.

Pension fund trustees have also increasingly considered outsourcing their investment accounting. The outsourcing of the investment accounting functions has increased in accordance with the use of a consultant to advise on the outsourcing move.

Watson Wyatt's search criteria is based on a due diligence process. "On an annual basis we send each participating custodian our own questionnaire accompanied by their prior year answers," says Brian Hill, a partner at Watson Wyatt. "By maintaining the database on as many custodians as possible or as are interested in working with pension funds, we can provide adequate support to our clients."

All custodians have their own sets of strengths and weaknesses and it is a case of marrying them up with a specific client.

Historically, pension funds are used to dealing directly with fund managers and insurance companies to satisfy their custody needs. As a result, trustees often still do not have an adequate grasp of the intricacies of custody and the service providers have had to improve the way they communicate to the trustee.

According to Hill, there are certain risks associated with specialist consultancy services. "Care has always got to be exercised to ensure that a selection process is done on a rational basis and extraneous and irrelevant factors are not taken into account," he says.

In addition to local authority and corporate pension funds, more investment managers use specialist consultants in their quest for a mid to back office outsourcing partner and to exploit value added services offered by back office providers. "Consultants are utilised based on their expertise and knowledge," says Amanda Field, consultant relations manager at ABN Amro Mellon and Mellon European Fund Services. "Pension funds continue to face pressure due to the Myners Report and other industry initiatives and will look towards specialist consultants. At the same time, investment management firms utilise consultants to assist with the search for a service provider who will meet their needs today and in the future."

"One of the requisites is that the consultant remains 'independent' and both parties are able to define what is in and what is out of scope," says Field.

According to Field, the extent to which consulting services are used depends on the client's individual requirements and budget. "Certain clients will make use of what I like to call 'component consulting' where the clients employ consultants to manage a portion of the entire review process, which could include the drafting and issuance of the RFP on behalf of the client, or perhaps the analysis of the response submitted by the various service providers, or only employing a consultant for the implementation phase of the transition," she says.

Looking ahead, the use of independent consultancy services is here to stay. Custodians are accepting this trend and are resolutely beefing up their consultant relations teams in order to win favour with both consultant and end user.

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