

WIRRAL COUNCIL

PENSIONS COMMITTEE

18 JUNE 2009

REPORT OF THE DIRECTOR OF FINANCE

CUSTODIAN SERVICES

1. EXECUTIVE SUMMARY

- 1.1 This report sets out the functions performed by the Global Custodian, recommends the take up of optional years within the existing contract, and proposes the use of a custodian monitoring service.

2. ROLE OF GLOBAL CUSTODIAN

- 2.1 Custodians hold a range of assets on behalf of their customers. Institutional investors, money managers and broker/dealers rely on custodians and other market participants for the efficient handling of their worldwide securities portfolios which is complicated by differing tax legislation, regulatory frameworks and time zones.
- 2.2 Custodians effect settlements of trades, i.e. completion of a transaction, whereby the seller transfers securities and financial instruments to the buyer, and the buyer transfers money to the seller.
- 2.3 Other mainstream tasks include:
- Collection of income due (dividends and interest due)
 - Application to reduced rates of withholding tax at source and reclaiming withheld taxes retrospectively
 - Notification and effecting corporate actions, e.g. rights issues, takeovers, bonus issues
- 2.4 Over and above these core services, custodians also offer other services. Examples which MPF purchases include investment accounting and securities lending. In addition, the custodian can provide an independent valuation to provide a cross check on the valuations provided by the asset managers.
- 2.5 In recent years there has been significant consolidation in the global custodian industry. As a result, prices of core custody services have reduced, as greater economies of scale are being achieved.
- 2.6 Security of assets held by the global custodian on behalf of MPF was set out in a report to the Investment Monitoring Working Party on 25 February 2009.

3. OPTION OF AN IN HOUSE CUSTODIAN FUNCTION

- 3.1 It is very rare for a local government pension fund to undertake its own custodianship. I am aware of only one fund which undertakes custody for its internally managed UK equities and UK bonds. As the MPF bond portfolios are externally managed in pooled vehicles, an in-house custody function could not apply to bonds. Unit charges (custody costs, transaction costs) for UK equities are low, as State Street acts as its own sub-custodian in the UK market.
- 3.2 With limited activity levels, MPF would need to gear up staffing levels and undertake extensive training, yet would not be able to enjoy the economies of scale which accrue to global custodians. I consider that the associated risks in establishing an in-house custody function for internal UK equity portfolio (e.g. managing market failure during contractual settlement deadlines, limited experiences of problem solving due to small volumes, potential loss of key staff, possible lack of staff cover) would outweigh any potential savings.

4. SECURITIES LENDING

- 4.1 MPF participates in a securities lending programme for its segregated holdings. Income is received from borrowers who pay a fee. Such income accrues both to the custodian (from which the costs are met) and to MPF on a negotiated fee split basis. Income received by MPF from securities lending may, in certain years, exceed the total expenditure on custodian costs.

5. CONTRACT WITH STATE STREET

- 5.1 The current five year contract was originally intended to run from October 2004 to September 2009, with an optional extension available of up to two years. The tender had an indicative value of £2.6m. However, due to due diligence and contract clarifications, the transfer from the previous custodian, the Bank of New York, to State Street was delayed until April 2005.
- 5.2 I wish to take up the option of extending the contract to September 2011. State Street has informally indicated their willingness to accept such an extension within the current price structure.
- 5.3 I would therefore in Autumn 2010 initiate a procurement process for re-tendering custodian services for the period October 2011 to September 2016.

6. CUSTODIAN MONITORING SERVICES

- 6.1 The recent turbulence in investment banking and the financial sector generally has increased both the awareness and the impact of the different risks associated with the investment industry. The heightened market volatility not only increases execution risk but also raises operational risk, as the potential cost of correcting mistakes is much higher in volatile markets.
- 6.2 Since the inception of the current contract, MPF has significantly increased the number of segregated mandates, reduced the scale of pooled funds, and also made additional investments in emerging markets, which involve higher custody and transaction costs. In addition, MPF has subscribed to the State Street investment accounting reporting system. As a consequence, the total monthly costs are double the initial 2005 levels due to this increased and diversified activity.
- 6.3 Custodian monitoring can involve seeking external advice as part of the custodian selection process. It would provide an informed view on the financial stability of the different custodians, ensuring MPF obtained a firm understanding of the fundamentals of each potential custodian. This can include advice on current performance levels of different custodians, current market level of custody and transaction fees, current market rates for cash deposits and percentage splits of securities lending markets. It could also cover a review of the draft contract of the preferred supplier, a course of action undertaken by MPF as part of the 2004/05 custodian procurement process..
- 6.4. In addition, periodic monitoring of performance can cover the following:
- Failed trades: number, how long outstanding, who was responsible, remedial action taken.
 - Income collection: has income been collected in time in non-contractual markets?
 - Tax reclaims: has outstanding tax been reclaimed and paid over in a timely manner?
 - Corporate actions: has client been recompensed for any missed corporate actions?
 - Counter party exposure: is there a concentration in counter party exposure across the scheme's activities?
 - Are there performance discrepancies between fund managers and custodian?
 - Efficiency of cash sweeping arrangements
- 6.5. All of the above could, potentially, improve the financial position of the Fund. Some performance aspects can be adequately monitored by MPF.

- 6.6. It is therefore proposed to draft a detailed specification for an appropriate custodian monitoring function and to initiate a tender procedure for such services.
- 6.7. It is possible that custody selection, custodian monitoring, and monitoring of securities lending could be subject to separate contracts.

7. FINANCIAL IMPLICATIONS

- 7.1. There is no provision for the current budget for a custodian monitoring service. If such a function is agreed, a small portion of the anticipated additional withholding tax received could be earmarked in the current year for such costs. Any ongoing costs would be built into future budgets.

8. STAFFING IMPLICATIONS

- 8.1 There are no staffing implications in this report.

9. EQUAL OPPORTUNITY IMPLICATIONS

- 9.1 There are none arising directly from this report.

10. COMMUNITY SAFETY IMPLICATIONS

- 10.1 There are no specific implications for any Member or Ward.

11. LOCAL MEMBER SUPPORT IMPLICATIONS

- 11.1 There are none arising directly from this report.

12. LOCAL AGENDA 21 IMPLICATIONS

- 12.1 There are none arising from this report.

13. PLANNING IMPLICATIONS

- 13.1 There are none arising from this report

14. BACKGROUND PAPERS

- 14.1 None

15. RECOMMENDATIONS

- 15.1. That Pensions Committee agrees to extend the existing contract with State Street as Global Custodian to 30 September 2011.
- 15.2. That Pensions Committee agrees that a procurement process commence for the selection of a custodian monitoring service.

IAN COLEMAN
DIRECTOR OF FINANCE

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