

Pensions Audit Sub Committee

2.00pm, Tuesday, 11 December 2018

Global Custody Services Performance

Item number	5.4
Report number	
Executive/routine	
Wards	All
Council Commitments	Delivering a Council that works for all

Executive Summary

This report presents the Key Performance Indicator Report for the 12 months ended 30 September 2018 provided by the Funds' custodian, Northern Trust. The purpose of this report is to demonstrate that the performance of the custodian is regularly monitored to ensure that the services provided meet the needs of the three Pension Funds.

The report highlights that the indicator for Corporate Actions elected within deadline has remained Red for the year. As per previous years, a majority of late responses related to an external investment manager (83% of late responses). From investigation, the Fund has comfort that these responses have not been late and the issue relates to how "default" corporate actions are being picked up between the manager and Northern Trusts system.

During the period, there was an improvement in the timeliness of receipt for the monthly asset valuation and financial reporting of the Fund. Previously delays were caused in the production of final valuation reports due to queries raised by the Fund.

The conclusion is that Northern Trust's services are currently meeting the needs of the three Pension Funds.

Global Custody Services Performance

1. Recommendations

Committee is requested to:

- 1.1 Note the report and highlight any points it would like to raise at the Pensions Committee on 12 December 2018.

2. Background

- 2.1 Following a competitive tender process, Northern Trust has provided investment custody services since early in 2011 for the three Pension Funds. Provision of these services is vital to the management of the Funds' investments. The range of services includes:
 - Safe custody of investment assets.
 - Reconciling investment valuations and accounts.
 - Ensuring that investment transactions are processed within market requirements.
 - Collecting investment income.
 - Providing notification of all corporate actions and passing responses to the companies concerned.
- 2.2 In order to assess the services provided a number of key performance indicators have been agreed with Northern Trust. These indicators are subject of a report from Northern Trust, the latest of which is for the 12 months ended 30 September 2018. The indicators cover the services listed above.
- 2.3 In addition, Northern Trust provides foreign exchange conversion and investment income tax services. The performance of these services is assessed in separate annual reports, with the former being considered by the Investment Strategy Panel. The only other significant service provided is securities lending, this revenue item being included in the budget and outturn figures which are also presented to Committee.
- 2.4 In February 2014's external consultancy review of the Funds' investment arrangements it was recommended that the Fund should conduct regular operational reviews of key outsourced providers and incorporate onsite visits with face to face meetings. Following this review the Fund has undertaken an annual site visit to Northern Trusts' offices in London for the past three years.

3. Main report

3.1 Information about all of the performance indicators is summarised below:

Month End Valuation Reporting

Description of Indicator	Month end valuation reports of investments completed and reviewed by Northern Trust and available to client within the target number of business days of end of the previous month.
Performance Traffic Lights	Green – Completed by business day 14 Amber – Completed by business day 15 Red – Completed by business day 16 or later
Service Rating Over 12 Months to 30/9/18	Green (Previous Report: Amber)
Comments	<p>Unreviewed valuations are available on business day one; these are accurate for quoted investments. Portfolios that contain unquoted investments take longer for valuation information to be obtained.</p> <p>Month end valuations provided by Northern Trust are reconciled with records maintained by the external or internal investment manager. In addition, checks are made on the prices used by Northern Trust and the prices used by the external or internal investment manager.</p> <p>On one occasion during the year, our accounts were signed off after the 14-day target (March 2018). The delay in sign off was as a result of queries submitted by the Funds' staff over asset valuations. Queries are regularly raised to improve the accuracy of the monthly valuations and are an essential part of quality assurance role played by the Funds' staff. Working proactively with Northern Trust helps to minimise future problems.</p>

Financial Reporting

Description of Indicator	Since April 2012, Northern Trust has been responsible for providing investment accounts for all three Pension Funds. This includes a month end trial balance and summary accounts and at the year end additional information for inclusion in the annual accounts.
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	Month end investment accounting packs should be completed and sent to the Fund within the target number of business days of end of the previous month.
Performance Traffic Lights	Green – Completed by business day 18 Amber – Completed by business day 19 Red – Completed by business day 20 or later
Service Rating Over 12 Months to 30/9/18	Green (Previous Report: Amber)
Comments	More time is allowed at the year end for the preparation of the additional information required for the annual accounts. The month end accounts are checked by the Fund for accuracy. Any delays in month end valuation reporting have a knock-on effect in completion of the monthly financial reporting.

Trade Settlement Statistics

Description of Indicator	Each investment market around the world has a set of requirements that must be followed regarding the settlement of trades (purchases and sales). These requirements include a fixed number of business days for a trade to be settled. For example, shares trade in the UK must be settled in a three-day period. Within that period each side must “deliver” either the shares or the cash as appropriate. The indicator is the percentage of trades that have settled on time.
Performance Traffic Lights	Green – 94% or higher Amber – 92% to 94% Red – lower than 92%
Service Rating Over 12 Months to 30/9/18	Green (Previous Report: Green 97.06%) 95.58%
Comments	During the period, there were a total of 5,065 trades of which 4,841 (95.58%) were settled on time. Of the 224 trades settled late, 197 were purchases and 27 were sales. This is due to a common market issue where the selling

	<p>broker does not initially have sufficient shares to settle the purchase trade.</p> <p>Northern Trust provides a range of reports on settlement statistics; this includes one that provides information by broker. This is particularly useful for identifying the source of settlement problems.</p> <p>Northern Trust provides contractual settlement on all trades. For sales, Northern Trust will credit the Fund with the cash proceeds on the contractual settlement date of the underlying trade regardless of whether it settles on time in the market. Northern Trust would then seek compensation by issuing a market claim against the purchasing broker.</p>
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Income Collection Statistics

Description of Indicator	<p>It is the responsibility of the custodian to account for all dividend income when it becomes due and to receive the money into the bank when the dividend is actually paid.</p> <p>The indicator is the percentage of the number of income payments received on pay day.</p>
Performance Traffic Lights	<p>Green – 95% to 100%</p> <p>Amber – 90% to 95%</p> <p>Red – lower than 90%</p>
Service Rating Over 12 Months to 30/9/18	<p>Green (Previous Report: Green 98.34%)</p> <p>98.50%</p>
Comments	<p>The performance indicator is based on the number of income collections rather than their value. During the period, there were a total of 2,397 income collections, 2,361 (98.50%) of which were received on the correct pay day.</p> <p>Northern Trust provides a range of reports on income receipts including one that provides information by country. This report is useful to identify any problems at the market, rather than individual company, level.</p> <p>Northern Trust provides contractual income in around 46 countries. This means that Northern Trust endeavours to credit the Fund's bank account with the income on its pay date irrespective of the actual date of receipt.</p>

Corporate Actions

<p>Description of Indicator</p>	<p>Corporate actions are events announced by companies that give shareholders the opportunity to make a decision on two or more potential choices. For example:</p> <ul style="list-style-type: none"> • Rights issue to buy additional shares • Dividend reinvestment in additional shares • Receive dividend in GBP, USD or EUR <p>It is the responsibility of the custodian to collate responses from its clients to corporate actions and communicate the results to the company. The Fund has the responsibility of responding to corporate actions on a timely basis.</p> <p>The indicator is the percentage of responses made by the client with the deadline date set by the company for a response.</p> <p>The Fund has the responsibility of responding to corporate actions on a timely basis. Responses are made by external and internal investment managers for the portfolios that they are responsible for.</p>
<p>Performance Traffic Lights</p>	<p>Green – 100%</p> <p>Amber – 95% to 99%</p> <p>Red – lower than 95%</p>
<p>Service Rating Over 12 Months to 30/9/18</p>	<p>Red</p> <p>93.52 % (Previous Report: Red 94.86%)</p>
<p>Comments</p>	<p>During the period, there were 463 corporate actions, 433 (93.52%) of which are recorded as having been responded to within the time limit.</p> <p>Northern Trust provide an online system to advise clients of all upcoming corporate actions. The same system is used by the client to record decisions. As the deadline for an action approaches and no response has yet been recorded, Northern Trust staff will attempt to contact the client for a response. Contact is initially made by e-mail and on the day prior to the deadline contact by phone is attempted. If a client response cannot be obtained Northern Trust will elect the default option for the action.</p> <p>Of the 30 late items 25 related to one of the Fund's external managers. After investigation, it was discovered that the issue relates to how certain default corporate actions are</p>

	<p>being captured between the manager and Northern Trust systems rather than late action.</p> <p>On assessment, the late corporate actions did not represent the potential for financial loss to the Fund.</p>
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- 3.2 On 11th October 2018 the Fund conducted its annual site visit to Northern Trust's London office. Areas covered included –

LGPS Asset Pooling	Discussion on the current developments in England and Wales following the creation of asset pools and the implications for Northern Trust.
Accounting/Valuation Reporting	Overview of the arrangements in place to ensure accuracy /consistency in the valuation basis of the Funds assets. Discussions on ongoing changes to CIPFA guidance and pressed on improvements to their own reporting with regards to the Cost Transparency Code, with reference to current FX and Money Market arrangements in place for the Fund.
Alternatives/Private Equity Monitoring	Review of arrangements in place to administer Funds' unlisted assets. Covered areas such as controls, staff and training arrangements. Exploring the possibility of having a direct customer liaison within the team.
Securities Lending	Overview of Lothian's current securities lending program and review of the controls/restrictions in place for program.
Cybersecurity	Provided with an overview of the Information Security Structure in place at Northern Trust, the types of threats faced and controls in place.
Business Continuity	An update and overview of the business continuity arrangements in place within Northern Trust.

4. Measures of success

- 4.1 Performance is measured against the indicators that have been set for the main services provided by Northern Trust.

5. Financial impact

- 5.1 The budget set for the provision of custody services for 2018/19 is £427k. This report has no impact on the cost of custody provision.
- 5.2 Poor performance of the custodian could have a financial impact on the three Pension Funds. For example: from delays in, or failure to, collect investment

income or failure in the system to notify companies of decisions made in response to corporate actions. However, staff monitor service provision and corrective action are taken if any issues arise.

- 5.3 The cost and quality of custody services are assessed as part of a rigorous competitive procurement exercise. Northern Trust was the winner of the last exercise and the initial contract was set for five years ending in February 2017, with the Fund choosing to take up its option to extend for a further three years to February 2020. Northern Trust has a strong presence in the LGPS market and has retained a high credit rating (AA-) for many years and has not been involved in high profile litigation cases with clients (in contrast to some other global custodians).

6. Risk, policy, compliance and governance impact

- 6.1 There are no risk, policy, compliance and governance impacts arising from this report.

7. Equalities impact

- 7.1 There are no equalities implications as a result of this report.

8. Sustainability impact

- 8.1 There are no sustainability impacts arising from this report.

9. Consultation and engagement

- 9.1 The Pension Board, comprising employer and member representatives, is integral to the governance of the Fund and they are invited to comment on the relevant matters at Committee meetings.

10. Background reading/external references

- 10.1 None.

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11. Appendices

None