

Pensions Audit Sub Committee

2.00pm, Tuesday, 10 December 2019

Global Custody Services Performance

Item number	5.4
Executive/routine	
Wards	All
Council Commitments	

1. Recommendations

The Pensions Audit Sub Committee is requested to:

- 1.1 note the report and highlight any points it would like to raise at the Pensions Committee on 11 December 2019.

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Global Custody Services Performance

2. Executive Summary

- 2.1 This report presents the Key Performance Indicator Report for the 12 months ended 30 September 2019 provided by the Lothian Pension Funds (LPF) 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 two pension funds;
- 2.2 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 (79% of late responses). From investigation, LPF 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;
- 2.3 The conclusion is that Northern Trust’s services are currently meeting the needs of the two pension funds.

3. Background

- 3.1 Following a competitive tender process, Northern Trust has provided investment custody services since early in 2011 for the pension funds. Provision of these services is vital to the management of LPF’s investments. The range of services includes:
 - safe custody of investment asset;
 - reconciling investment valuations and accounts;
 - ensuring that investment transactions are processed within market requirements;
 - collecting investment income; and
 - providing notification of all corporate actions and passing responses to the companies concerned.
- 3.2 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 2019. The indicators cover the services listed above.

- 3.3 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.
- 3.4 In February 2014's external consultancy review of LPF's investment arrangements it was recommended that LPF should conduct regular operational reviews of key outsourced providers and incorporate onsite visits with face to face meetings. Following this review, LPF has undertaken an annual site visit to Northern Trusts' offices in London.
- 3.5 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 LPF taking up its option to extend for a further three years to February 2020. Pensions Committee has also approved the additional extension of this contract to February 2022 whilst Scottish Government consultation on the structure of the LGPS continues. 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).
- 3.6 Internal audits scope of work for 2019/20 includes the review of key controls used to support the custodial services provided by Northern Trust to LPF. The findings of this will be reported to Committee in due course.

4. Main report

- 4.1 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 30/9/19	Green (Previous Report: Green 14 days) 13 days
Comments	Unreviewed valuations are available on business day one, accurate for quoted investments. Portfolios that contain unquoted investments take longer for valuation information to be obtained. Month end valuations provided by Northern Trust are reconciled with records maintained by the external or

	<p>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 two occasion during the year, our accounts were signed off after the 14-day target (October 2018 and March 2019). The delay in sign off was as a result of queries submitted by LPF's 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 LPF's staff. Working proactively with Northern Trust helps to minimise future problems.</p>
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Financial Reporting

Description of Indicator	<p>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.</p> <p>Month end investment accounting packs should be completed and sent to LPF within the target number of business days of end of the previous month.</p>
Performance Traffic Lights	<p>Green – Completed by business day 18</p> <p>Amber – Completed by business day 19</p> <p>Red – Completed by business day 20 or later</p>
Service Rating Over 12 Months to 30/9/19	<p>Green (Previous Report: Green 16 days)</p> <p>17 days</p>
Comments	<p>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 LPF for accuracy. Any delays in month end valuation reporting have a knock-on effect in completion of the monthly financial reporting.</p>

Trade Settlement Statistics

Description of Indicator	<p>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.</p>
Performance Traffic Lights	<p>Green – 94% or higher</p> <p>Amber – 92% to 94%</p> <p>Red – lower than 92%</p>
Service Rating Over 12 Months to 30/9/19	<p>Green (Previous Report: Green 95.58%)</p> <p>95.79%</p>

Comments	<p>During the period, there were a total of 4,999 trades of which 4,783 (95.79%) were settled on time. Of the 216 trades settled late, 184 were purchases and 32 were sales. This is due to a common market issue where the selling 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 LPF 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	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. The indicator is the percentage of the number of income payments received on pay day.
Performance Traffic Lights	Green – 95% to 100% Amber – 90% to 95% Red – lower than 90%
Service Rating Over 12 Months to 30/9/19	Green (Previous Report: Green 98.50%) 98.48%
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 2,305 income collections, 2,271 (98.48%) 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 LPF's bank account with the income on its pay date irrespective of the actual date of receipt.</p>

Corporate Actions

Description of Indicator	<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; and • receipt of dividend in GBP, USD or EUR.
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	<p>It is the responsibility of the custodian to collate responses from its clients to corporate actions and communicate the results to the company. LPF has the responsibility of responding to corporate actions on a timely basis. The indicator is the percentage of responses made by the client with the deadline date set by the company for a response.</p> <p>LPF 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>
Performance Traffic Lights	<p>Green – 100%</p> <p>Amber – 95% to 99%</p> <p>Red – lower than 95%</p>
Service Rating Over 12 Months to 30/9/19	<p>Red 91.20 % (Previous Report: Red 93.52%)</p>
Comments	<p>During the period, there were 443 corporate actions, 404 (91.20%) 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 39 late items 31 related to one of LPF's external managers. After investigation, it was discovered that the issue relates to how certain default corporate actions are being captured between the manager and Northern Trust systems rather than late action.</p> <p>On assessment, the late corporate actions did not represent potential for financial loss to the pension funds.</p>

Due Diligence Annual Review

- 4.2 LPF visited Northern Trust's office in London on 8 November 2019 to undertake requisite detailed review of the banking operations and control environment. A comprehensive report covering LPF's findings for this year's due diligence will be provided to Committee at its next meeting in March 2020.

5. Next Steps

- 5.1 Service provision by Northern Trust, as global custody services provider, is subject to ongoing monitoring by LPF.
- 5.2 As stated above, a further assurance report will be provided to Committee in March 2020. In future, it is intended that the timing of the site visit should be brought

forward so that a single report on due diligence and performance review of global custodian services could be provided.

- 5.3 Internal Audit's findings on the Northern Trust controls for supporting LPF's custodial services will be presented to Committee in due course.

6. Financial impact

- 6.1 The budget set for the provision of custody services for 2019/20 is £427k. This report has no impact on the cost of custody provision.
- 6.2 Poor performance of the custodian could have a financial impact on the underlying 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.

7. Stakeholder/Community Impact

- 7.1 The Pension Board, comprising employer and member representatives, is integral to the governance of the pension funds and they are invited to comment on the relevant matters at Committee meetings.
- 7.2 There are no adverse health and safety, governance, compliance or regulatory implications as a result of this report. The forward planning of the Committees' agendas should facilitate improved risk management and governance for the pension funds.
- 7.3 There are no adverse sustainability impacts arising from this report.

8. Background reading/external references

- 8.1 None.

9. Appendices

- 9.1 None.