

“Core” vs. “Value-Added” Custody

Is There a Distinction?

By Alasdair Reid

The pensions industry has come a long way in recent years. The amount of media attention devoted to pensions issues, the increasing number and use of pension consultants, and the prominence of forums such as the NAPF underscore how far pension funds have progressed in the past decade. As the self-awareness of pension funds has increased, their need for and usage of custody services has evolved as well. As more and more providers drop out of the market, more pension funds are seeing the tangible benefits of using a single global custodian. This consolidation has been driven by a number of factors, but cost has been foremost among them, and as fund trustees consider the future of the industry, evaluation of which custody services are “core” and which are “value-added” – or indeed, if these labels remain relevant – is of paramount importance.

Not all that long ago, core custody encompassed simply safekeeping and settlement. As master recordkeeping has become more advanced, the list of core competencies now includes income collection, tax reclaims, corporate actions and proxy voting. But *caveat emptor* – just because a service is labelled as “core” doesn’t mean some custodians won’t charge for it on an item-by-item basis. Pension funds should always investigate these costs, as fees of £10 per notification or posting can quickly become far removed from what a pension fund may consider reasonable for “out-of-pocket expenses.”

Investment accounting is also now considered part of the “core” custody offering, although generally there is an additional charge for the service. The dwindling number of third-party investment accounting providers is proof of its acceptance into the fold of core products. Indeed, global custodians are now more likely to

provide investment accounting than specialist third parties. Cost, technology and efficiencies in data transfer have been key drivers behind this trend.

It is more obvious why securities lending and commission recapture would be considered “core.” Which is more efficient for each service: five small programs or one large one? Pension fund deficits, low returns and a low interest rate environment make the consolidated approach easy to justify.

Custodians which incorporate their own investment management businesses will rightly claim they are best placed to manage transitions when pension funds rearrange managers or rebalance according to a changing investment strategy. Therefore, transition management could very easily be seen as a core service, for master recordkeepers are best placed to see the bigger picture in this type of reorganisation.

Performance measurement is a bit of a grey area: should a pension fund rely on its managers, its custodian, or employ a performance measurement specialist? It’s a difficult question, although the choice is typically made by the fund trustees. Some funds may require separation between performance measurement and custody, especially those which similarly split investment accounting, although whether this is either necessary or cost-efficient is open to debate. The optimal arrangement might be to use a supplier which can provide custody and fund accounting efficiently but has the capability to provide both performance reporting and objective performance evaluation. In any case, the value-added element of performance measurement lies in what you do with the core numbers. What matters is how those numbers are interpreted, and how they help funds make better investment decisions. And while many providers may appear to offer similar services, closer inspection will reveal huge variations in the quality and expertise of the performance research and consultancy behind them.

Pension fund size becomes a factor when a fund considers a bundled “one-stop shop” solution rather than divesting to a number of providers. Larger funds might not get the value-for-money they deserve from a variety of service providers; smaller funds certainly won’t. Data exchange between service providers may create delays in performance and report delivery, and it is unlikely to enhance the integrity of the finished product. As custody services become increasingly commoditised, one wonders if consultants keep the idea of “best of breed” alive in an attempt to add value to the selection process.

The key factors influencing a pension fund’s selection of a global custodian are likely to be price and value for money, scope of service, contractual terms (i.e. are my key buying criteria being addressed?) and, importantly, client service. For pension funds abiding by the Pensions Act, FSA guidelines and industry best practice, it becomes difficult to counter the compelling arguments for a single custodian: all of the pension fund’s service requirements appear to be part of a core custody offering. Transparency issues do exist, but a bundled package allied with full transparency would appear to be the optimum pension fund custody solution.

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