THE ESSENTIAL LINK IN THE CHAIN

Translation of 'Onmisbare schakel in de keten' (the essential link in the chain): an interview with Northern Trust on the role of a custodian by Dutch fiduciary manager, Blue Sky Group. The article was published in Blue Sky's magazine, Blauw, in December 2014.

Pension schemes invest their funds, as investment returns are crucial to meeting the pension promise.

This requires investment expertise but also great care in looking after that big 'pot of money'.

The custodian plays an essential role in this process and this role has only increased after the financial crisis.

We speak with Frans Hofkens, senior vice president, Institutional Investor Group, Netherlands, Northern Trust.

'Most importantly, we ensure that assets are safely kept and managed. So quite simply put, we watch over that pot of money and we report on that,' according to Hofkens. In the wake of the financial crisis, these issues are receiving considerably more attention. 'For institutional investors the crisis has instilled a growing need for transparency and detailed understanding of their investments. We are meeting those needs. We provide oversight and offer insight so that pension schemes can take well-founded decisions. For instance with regard to risk exposure, or compliance, we help schemes to monitor if asset managers are complying with rules and agreements.'

Global oversight

This is part of a scheme's risk management. If an organization invests in an international portfolio of securities, custody and administration of those securities is carried out locally. The custodian keeps account globally via a network of sub-custodians.

'Take for instance common stock that will at some point pay out dividend. The custodian will notify the client of the pay-out ahead of time, he will ensure that the pay-out is made, that all associated fiscal aspects are clear, and that everything in that regard has been taken care of properly. We monitor the established investment guidelines and we report any deviation from those rules.

We also engage directly with the asset managers, and report back to the pension scheme. This allows schemes to meet requirements based on the correct information. This way we contribute to a pension scheme trustee board being in control.'

Expertise and scale

The pension fund is often not equipped to carry out the tasks of a custodian – as these are specialist areas which require significant expertise and global scale.

For example, in consultation with clients Northern Trust has enhanced its investment reporting to ensure that reporting solutions meet requirements of the new Financial Framework in accordance with Dutch Central Bank guidelines. The reports provide valuation data, cash flow modelling and stress test analysis, allowing pension funds to demonstrate that they have appropriate investment controls, data integrity and adequate risk models at their disposal. This enables pension schemes to measure sensitivity to market shocks and the impact this may have on plan participants.

Actively engaged in market developments, Northern Trust participates in the Working Group DNB Pension Fund Reporting - a working group headed by the Dutch Central Bank comprising experienced pension fund managers and financial analysts, which is focused on developing standards that respond to ever-increasing investment complexity.

More rules, more stringent requirements

Hofkens mentions two governance related trends that have specific relevance to the role of the custodian: ‘On the one hand, rules and regulations such as the new Enhanced Pension Fund Governance Act introduce new and more stringent requirements. And on the other hand, the regulator has tightened governance requirements for the investment chain as a whole.’ The search for more security, triggered in part by the financial crisis, is leading to a sharp increase in regulatory pressure. Regulations such as AIFMD and EMIR are part of this trend. The Alternative Investment Fund Managers Directive (AIFMD) is a European directive establishing a harmonized regulatory framework that regulates alternative investment fund managers as of July 2013.

The European Market Infrastructure Regulation (EMIR) regulates OTC derivative markets. Pension schemes, which frequently use these instruments, are exempt from central clearing for the time being (recently extended to August 2017) but do have to meet other requirements related to the directive, particularly with regard to risk control measures and transaction reporting. Hofkens notes that these developments contribute to the changing role of custodians: ‘We are seeing a shift from traditional custodian to specialized provider of institutional governance services. This means that as a custodian you actively take note of what’s happening in the market, discuss the impact with your clients and jointly consider which steps might be taken to deal with the issues in a timely manner so as to mitigate the impact. In addition to our existing responsibilities we increasingly act in a strategic advisory role. We believe that this advisory role will become more important in the coming years.’

Robust sparring partner

The two governance trends mentioned obviously also affect pension funds. Hofkens: ‘This is very time consuming for pension funds, it imposes a heavy burden on our clients. You see, everybody agrees on the need for transparency, but the trick is to strike the right balance when meeting transparency requirements, so that pension funds do not have to spend all of their time filing reports. Regulatory pressure will definitely not be reduced in the short term, but the institutional market has learned lessons regarding the best way to deal with this by correctly and promptly interpreting requirements and efficiently implementing new methods.

The market has become better at this. At the same time these developments lead to further consolidation. Scale has become necessary simply to meet regulatory requirements. In addition we see that knowledge and expertise are increasing, not just because regulatory requirements have been tightened, but also and mainly because pension funds themselves consider this a priority. As a result, schemes have become more robust sparring partners, and that is great as it enhances the quality of the entire process. This way, we join forces to achieve the highest possible reliability.’

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