Watcher in the night

The days when pension funds could afford to adopt a casual attitude to investment monitoring are drawing, unmourned, to a close. Furthermore, the days when trustees could sleep soundly at night simply because they knew that their custodians were - at least in principle - handling their investment monitoring needs are also on the wane. Katherine Johnson, who is responsible for the business development of the OpenAIR Investments solution at the London-based pension software vendor, Euraplan, looks at the importance of independent verification

THESE ATTITUDES ARE BEING REPLACED BY a more responsible new approach to investment monitoring on the part of pension funds. More and more funds – especially those larger than about £50 million – are taking the attitude that investment monitoring is simply too serious a matter to delegate to others who may not be as committed to doing the job properly as the funds are themselves.

There are two main reasons why so many pension fund trustees are starting to place a new emphasis on taking complete responsibility for their own investment monitoring. Firstly, there is the sheer sense of duty to the fund's beneficiaries. After all, they are the people for whom the fund exists, and recent court cases have shown that they are entitled to expect the trustees to act in their best interests at all times. The fact is that proper investment monitoring has the potential to protect funds against such serious and alarmingly common mistakes as, for example, due dividends not being received on time or at all and incorrect debits being made from bank accounts.

When these problems strike, it is often extremely difficult to spot them unless investment monitoring is being undertaken in a precise, disciplined, comprehensive and entirely consistent manner. Yet why would pension fund trustees be satisfied with any approach to investment monitoring that was not all of these things? After all, the trustees of a pension fund are entirely responsible for the money in the fund; surely it is a crucial part of this responsibility that the trustees want investment monitoring to be undertaken properly. The pension fund trustee of today has to confront responsibilities which were often regarded less seriously in the past than they deserved to be.

The second reason why investment monitoring needs to be seen in a much more serious light today is the regulatory justification. Even after the passage of the Pensions Act 1995, the regulation of pension funds remains surprisingly complex, with a variety of parties ranging from the Inland Revenue's Pension Schemes Office (PSO) to the Occupational Pensions Regulatory Authority (OPRA), to the Pensions Research Accountants Group (PRAG) and others, all being involved. Some regulators have more teeth on the investment monitoring front than others.

In particular, the PRAG guidelines advise trustees to establish and maintain independent or third party verification of outsourced functions such as fund manager activity. The PRAG guide, 'Outsourcing for Trustees', has issued this highly

sensible advice as a core part of risk management for trustees. Trustees will know all too well that when things go wrong, the fact that functions are outsourced does not remove responsibilities from them.

Indeed, OPRA is explicit about the fact that, ultimately, it is the responsibility of the trustee to ensure that all outsourced activities are being carried out properly. OPRA has the power to fine and even launch criminal proceedings against pension fund trustees who do not comply with legal requirements, regardless of whether the activity is carried out in-house or not. OPRA has teeth, and may even in the future opt more for civil actions than for criminal ones, as experience suggests that the case may be more likely to be won if it is a civil case that is launched. In fact, OPRA retains criminal powers but civil powers allow it to penalise offenders more quickly.

And, of course, let us not forget that in any industry there is an undisputed need to comply with a code of best practice. This need is all the more important in the pension fund industry, whose complexity and enormous economic and social importance places a heavy burden on all those involved in the industry to be accountable. Of course, recommendations and regulations exist to protect pension scheme beneficiaries. Some of these are already legal requirements enforceable by OPRA; others are currently part of the guidelines and the Statement of Recommended Practice (SORP) for financial reports issued by PRAG. However, one often finds that advice that starts as recommended practice usually becomes enforceable by law sooner rather than later. It is in the best interest of a pension fund to comply with the recommendations before they become law, and surely any trustee worthy of the name is going to want to keep at the forefront of compliance, not lag behind until pushed into it by legal threats?

A BIG PART OF THE REASON WHY REGULATORY PRESSURE matters so much nowadays is that on a purely practical and mathematical level, as funds are employing more and more external fund managers in order to diversify their investments, the risks and the margin for error naturally increase. These risks include any financial issue that has not been dealt with properly and swiftly by the fund managers and of which the trustees are unaware.

The need for trustees to understand and monitor the activities that have been allocated to outside service organisations such as fund managers is paramount. The sheer volume of written material and advice that advisory bodies such as PRAG are making available to pension fund trustees underlines this need.

All said and done, this task is not a simple one. The monitoring requirements of a pension fund can be surprisingly complex. They would typically cover the following areas.

Reporting: pension funds need to pull down figures from investment reports to slot into their year-end accounts. This is not always manageable as the reports supplied by custodians and fund managers often don't break down income or market value into UK equities, UK fixed interest and into interest-linked categories. Note that these are the SORP reporting requirements.

Johnson: pension funds are confronting new responsibilities

Reconciliation: pension funds need to have a system that will reconcile back to the fund managers. Another consideration is that there needs to be a check to ensure that dividends are paid on the due date and that tax is collected on time. Missing tax is a serious problem as reclaimed tax is important for pension funds, especially for big ones.

Who exactly is best placed to administer the checks? Firstly, and perhaps the answer that springs to mind automatically at the moment, is to entrust this responsibility to custodians. After all, custodians already play a key and essential role in many areas relating to fund administration.

They are for most large pension funds an essential resource for activities such as corporate action reporting, securities lending, tax reclamation, divided collection and so on. Most global custodians do offer accounting services, which include the preparation of monthly/quarterly valuations, trade lists and income lists. If the client specifies it, this service will also include reconciliations with the fund manager's records. Some custodians, such as Northern Trust, offer a complete