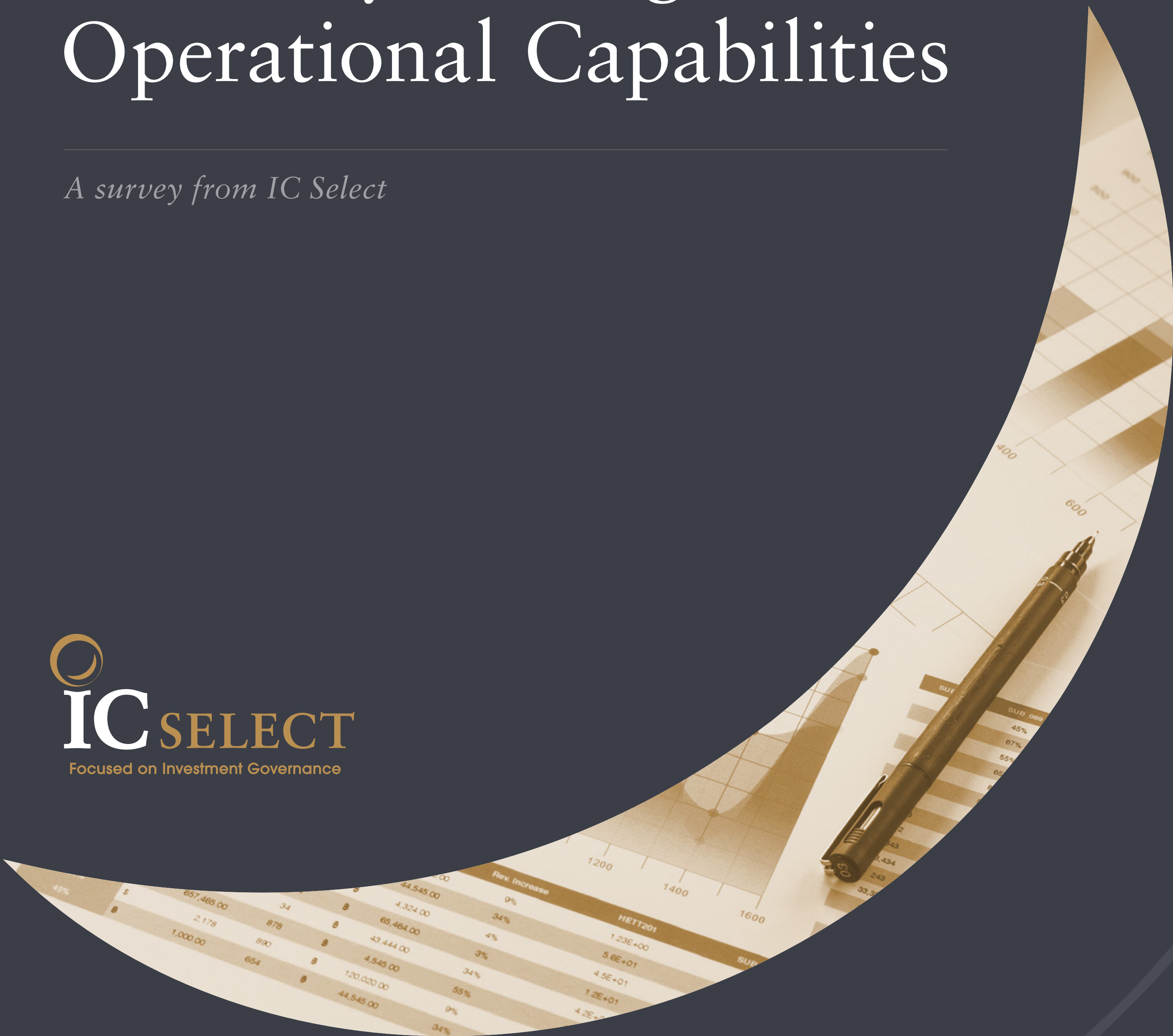
January 2022

Fiduciary Managers' Operational Capabilities

A survey from IC Select



IC SELECT
Focused on Investment Governance

www.ic-select.co.uk

Executive Summary

Welcome to IC Select's survey of the operational capabilities of fiduciary managers. This is the first time that we've published the findings of our due diligence in this area of fiduciary management. This is an important area for trustees to consider, as shortcomings in the way their fiduciary manager operates can lead to a loss of value for a pension scheme.

According to The Pensions Regulator, trustees must consider the suitability of their fiduciary manager, not only during the appointment process but also as part of ongoing monitoring. As well as assessing the decisions that fiduciary managers make about investments, trustees also have to look at their wider service provision, including how well they safeguard a scheme's assets.

In this survey, we present our findings in six main areas that are central to understanding the suitability of a fiduciary manager. We look at the way that operational systems can work together (platform integration), the efficiency of market transactions made on behalf of the fund (execution) and how well a manager handles the process of taking on a client portfolio from another manager (transition management).

We also examine the strength of their strategic partnerships (custody and asset-servicing partnerships), how effectively they manage data (data and reconciliation) and their processes for identifying and managing operational risks (operational risk management).

Our main findings were:

- Fiduciary management platforms are in healthy shape; 64% of managers have optimal levels of integration into a firm-wide enterprise platform.
- More than a third (or 36%) of fiduciary managers have developed a proprietary execution framework for carrying out trades in the underlying assets; this improves transparency and provides the opportunity to reduce transaction costs.
- Proprietary execution services, including for securities and foreign exchange, could save the average fund 0.22% per year in transaction costs, according to our estimates.

- A fifth (or 20%) of fiduciary managers have in-house specialist transition teams and also provide transition services to third-party fund managers. These firms will have better resources and expertise for carrying out transitions and are able to manage 'out-of-market' risk more effectively.
- More than a third (or 36%) of fiduciary managers have strategic partnerships with custodians and asset-servicing providers that are designed to save on costs of custody, mitigate operational risks, evolve their platforms and foster innovation.
- Less than a third (or 29%) of managers have a robust and prominent risk management framework.
- There is a lack of transparency around the disclosure of operational losses and payments made in compensation. Only 31% of fiduciary managers provided these figures.
- While fiduciary managers report minimal operational disruption during the pandemic, 77% of them reported an increase in operational control exceptions. Overall in 2020, isolated instances of control failings increased by 174% compared with 2019.

Methodology

Detailed questionnaires were sent to participants in the survey. This report is based on IC Select's analysis of their responses. A total of 15 fiduciary managers took part. We would like to thank the following for their participation: Aon, BlackRock, BMO, Cardano, Charles Stanley, Cambridge, GSAM, Kempen, LGIM, Mercer, River and Mercantile, Russell Investments, Schroders, SEI, and Willis Towers Watson.

Where they were provided, we also reviewed the independently commissioned statement of operational control (SOC reports), which all firms must produce in line with accounting standards.

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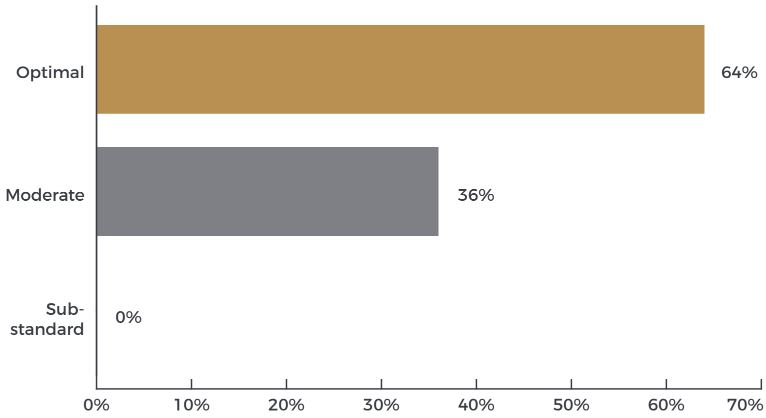
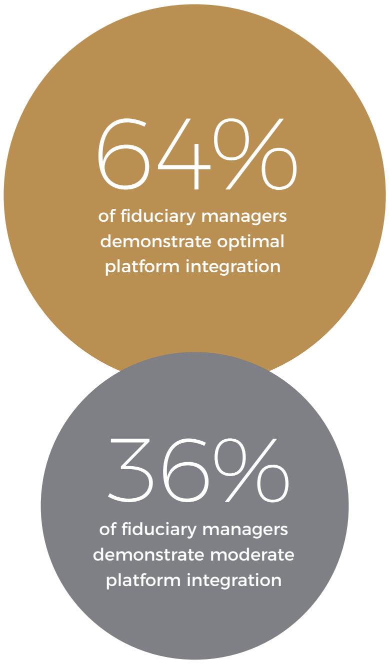
1. Platform Integration

LEVEL OF PLATFORM INTEGRATION



SOURCE: IC Select Research of the FM Universe



Several models and approaches to platform architecture exist within the fiduciary management sector. Through our research, we have developed a methodology to assess the levels of platform integration based on a fiduciary manager's commitment to technology that is simple, robust and scalable.

Platform integration refers to the holistic way that operational systems can work together. Fiduciary managers differ in the extent to which their operational controls and mechanics are integrated into a single system – an enterprise-wide approach. Some offer different modules, the output of which is combined to create an overview. For example, a fiduciary manager may have separate operational modules for derivatives and listed market assets. The coordination and integrity of data amalgamation will then be more challenging than if it was held in a single enterprise-wide system.

Firms with lower levels of integration may have less scalable platforms and be more susceptible to operational risk and inefficiency. This inhibits growth, the ability to adapt and the quality of client service and reporting when systems are stressed.

DEFINITIONS

'Optimal'

These fiduciary managers have a clear and appropriately resourced strategy to operate a platform that accommodates all asset classes and is used across the fiduciary management business regardless of geography or, where relevant, corporate legacy. The platform's data sources are centralised and well governed.

'Moderate'

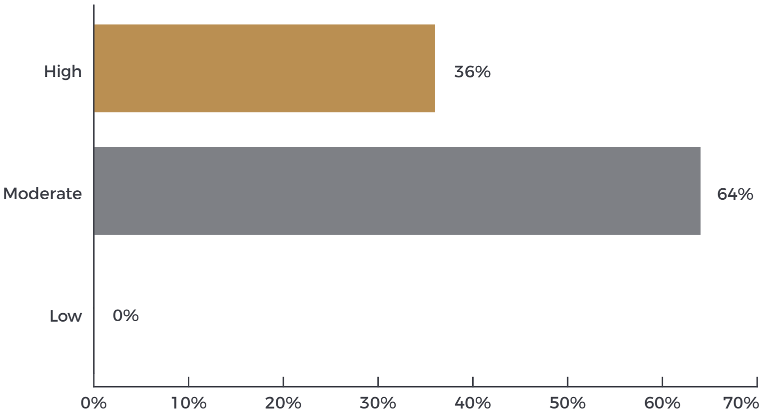
These fiduciary managers have robust and well-supported platforms but there are elements in the architecture that are separate due to asset class or transaction lifecycle. For example, these fiduciary managers may have different components for liability-driven investing and growth-asset-related trades or they might require manual hand-offs between fund management, compliance and operational steps.

'Sub-standard'

These fiduciary managers operate a high level of manual processing and experience significant risks in the reconciliation between components.

2. Execution

EFFICIENCY OF EXECUTION



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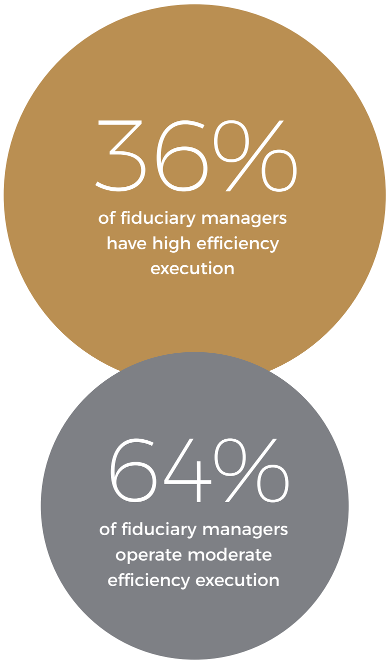


Execution is defined as the buying and selling of individual securities and foreign-exchange transactions on behalf of the fund. Fiduciary managers' execution models are driven largely by how they access the markets. This might be through their own funds or via third-party managers. However, levels of control and oversight vary even when third-party managers are used. Employing models that distance execution may obscure trading metrics and severely restrict opportunities for efficiencies such as crossing and aggregation of trades.

Inefficient execution increases costs and execution risk for a fund, while efficient execution increases transparency, accountability and confidence. It can also save costs. We estimate that, for a typical fund, the difference between high-efficiency execution and moderate-efficiency execution could increase costs by 0.22% per year.

Many managers are either unable or choose not to measure or benchmark the efficiency of their execution. As a result, it is difficult to target improvements in performance.

DEFINITIONS

'High Efficiency'

These fiduciary managers have dedicated trading units. They harness market presence, the crossing and aggregation of trades and the netting off of opportunities to minimise explicit and implicit trading costs. They use & continuously develop technology that optimises order management and market connectivity. They also actively measure and benchmark their trading performance, including in their commercial relationships with counterparties.

'Moderate Efficiency'

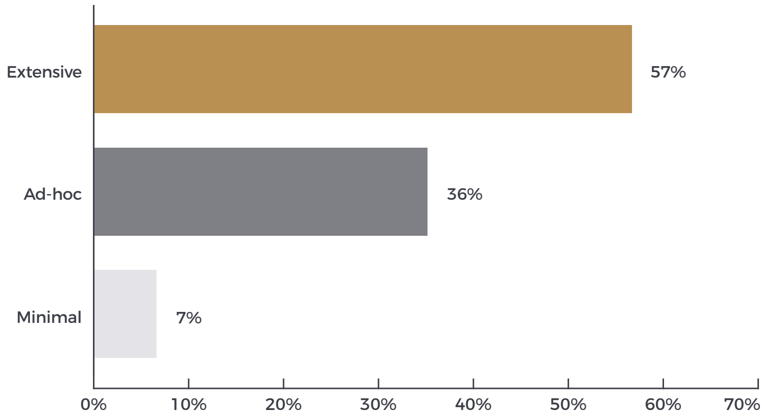
These fiduciary managers either partly or fully rely on external counterparties for execution. They carry out regular due diligence of these activities and put in place appropriate governance, evidenced by the visibility of relevant policies and the disclosure of external counterparties.

'Low Efficiency'

These fiduciary managers either partly or fully rely on external counterparties for execution. However, there is little or no consideration of the execution performance of underlying counterparties.

3. Transition Management

PROVISION OF REPORTING



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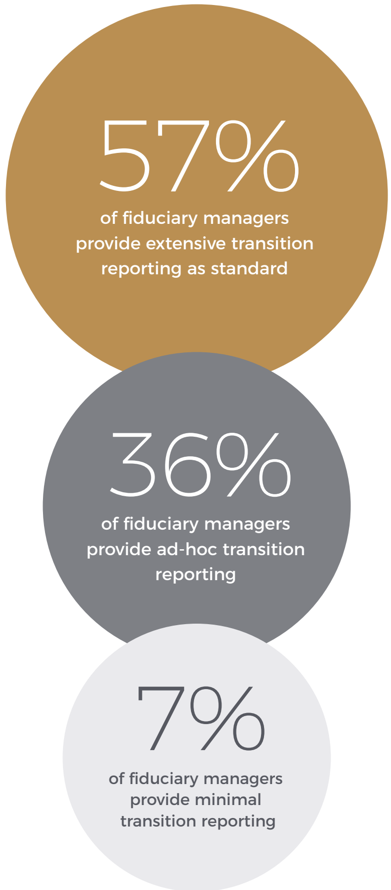


Our research looked at each fiduciary manager's approach to managing the take-on of portfolios, and examined the reporting that was provided to clients before, during and after a portfolio transition.

Major transitions are always a concern for trustees. Clarity, flexibility, cost control and communication are paramount in ensuring client confidence in their fiduciary manager. Where these are sub-optimal, trustees may feel they need to spend more time overseeing the transition than is typically necessary.

DEFINITIONS

'Extensive Reporting'

These fiduciary managers provide clear summaries of their approach to each transition. Where appropriate, they also provide granular analysis. Cost estimates are adequately explained, and post-transition reports clearly detail outcomes in terms of timeline and cost compared with initial estimates.

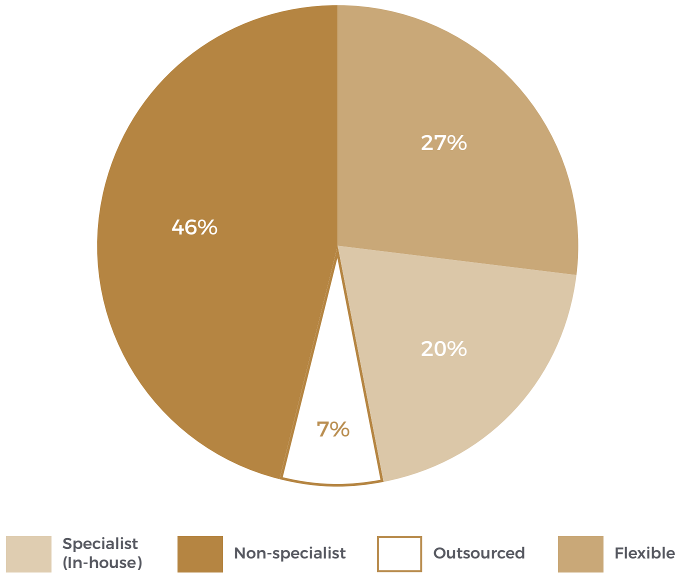
'Ad-hoc Reporting'

Transitions are adequately planned and executed, but detailed reporting may not be standardised.

'Minimal Reporting'

These fiduciary managers provide little or no reporting as standard.

TRANSITION MODELS



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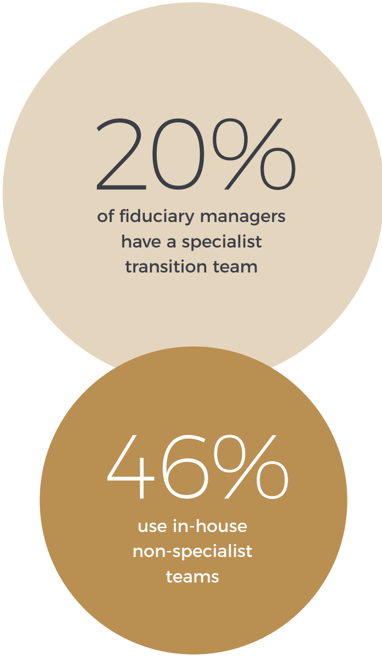

Fiduciary managers' approaches to transition management can be categorised into four models:

- Firms with specialist transition services
- Non-specialist
- Outsourced
- Flexible

Generally, firms that have an in-house specialist transition service will have better resources and the expertise to carry out transitions to the benefit of clients; they are also able to manage out-of-market risk more effectively. Those fiduciary managers that outsource transitions to specialist managers will also benefit from the enhanced capabilities of a specialist transition manager.

However, this outsourcing comes at an additional cost to the fund. In-house, non-specialist transition teams will typically be effective in transitioning pooled fund solutions but will be limited when it comes to restructuring individual securities within funds. Where necessary, they will often delegate this restructuring to the receiving third-party manager.

DEFINITIONS

'Specialist'

These fiduciary managers have a dedicated in-house transition management team that provides services to third parties and the firm's fiduciary management clients. They also support the fiduciary manager's ongoing transitions, such as significant asset allocation switches or fund mergers.

'Non-specialist'

These managers typically have dedicated teams that oversee and execute transitions, but they have a more limited ability to reorganise portfolios and manage out-of-market risk as effectively.

'Outsourced'

The standard approach of these managers is to engage a third party to manage transitions. They often engage the services of firms in the 'specialist' category described above.

'Flexible'

This group generally perform transitions in-house but they will engage third-party managers when the client stipulates, or if particular expertise is required due to the nature of the transition.

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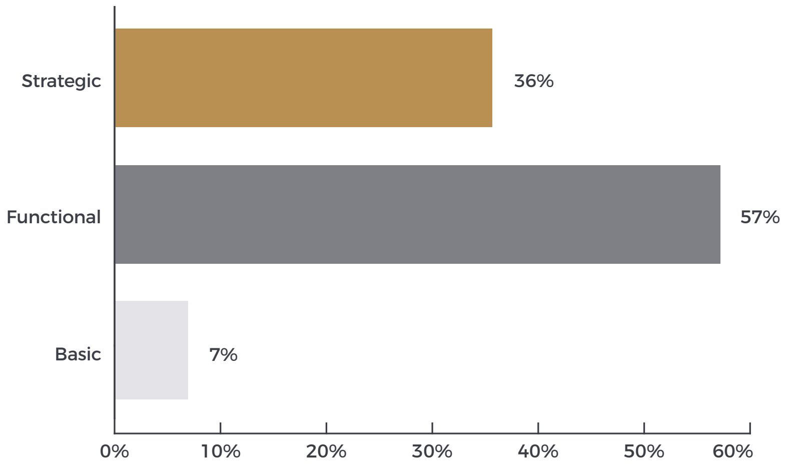
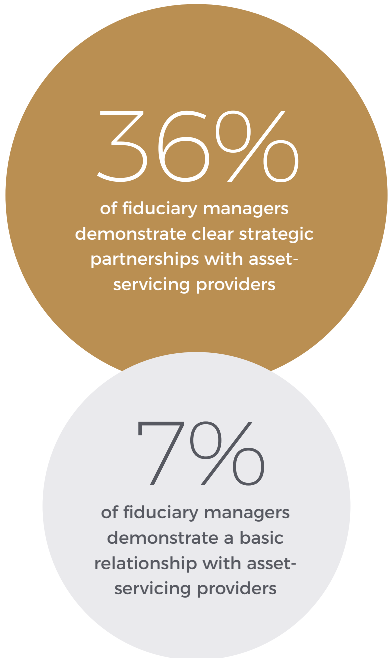
4. *Custody & Asset-Servicing Partnerships*

NATURE OF RELATIONSHIP



SOURCE: IC Select Research of the FM Universe



The nature of the relationship between the fiduciary manager and the custodian informs the overall efficiency of the fund. The key factor is the extent to which the fiduciary manager collaborates with the custodian to develop specific solutions for their clients through strategic partnerships, as opposed to engaging in a purely functional relationship.

This aspect of fiduciary management in practice often goes hand in hand with platform integration. Those managers with effective strategic partnerships will be able to reduce costs, deliver enhanced reporting, innovate more rapidly to meet the needs of their clients and mitigate operational risks.

DEFINITIONS

‘Strategic Partnership’

These fiduciary managers establish collaborative strategic partnerships with custodian/asset-servicing providers to develop and innovate the platform, operating model and value-added services. They have robust frameworks in place to manage relationships and service levels are measured and benchmarked.

‘Functional Relationship’

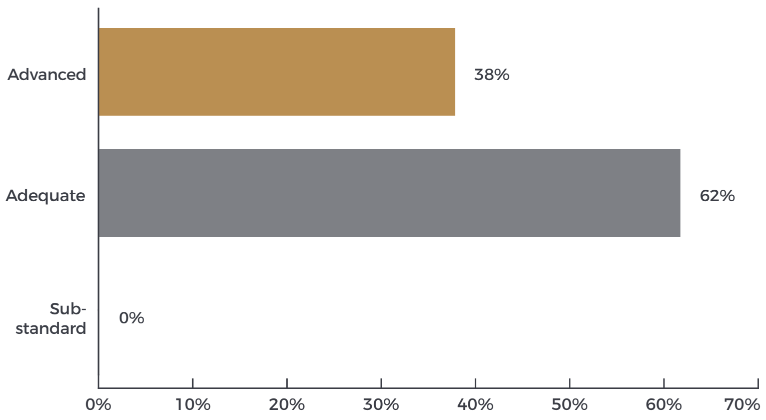
These managers will typically be flexible and robust in the way they work with custodians and asset-servicing providers. Their engagement is purely functional with little or no evidence of collaboration around strategy and innovation.

‘Basic Relationship’

Typically servicing smaller clients with more limited custodian requirements, these fiduciary managers lack the scale or complexity to benefit from the full-service range of custodian/asset-servicing providers.

5. *Data & Reconciliation*

STANDARD OF MODELS



SOURCE: IC Select Research of the FM Universe

38%
of fiduciary managers have advanced data & reconciliation models

62%
of fiduciary managers have adequate data & reconciliation models

Data management and reconciliation is the process, technology, strategy and governance supporting the provision of data to portfolio managers and client reporting.

Out-of-date, inaccurate or inconsistent data can lead to mistakes or delay decisions to the detriment of performance, operational costs or client reporting.

DEFINITIONS

'Advanced'

These fiduciary managers always have highly current information, with either an intra-day update or previous day's close. They centralise their core data sources and there is clear evidence that a 'golden record' approach, or single, well-defined version of all data, is used throughout the business. There is a clear and evolving data strategy.

'Adequate'

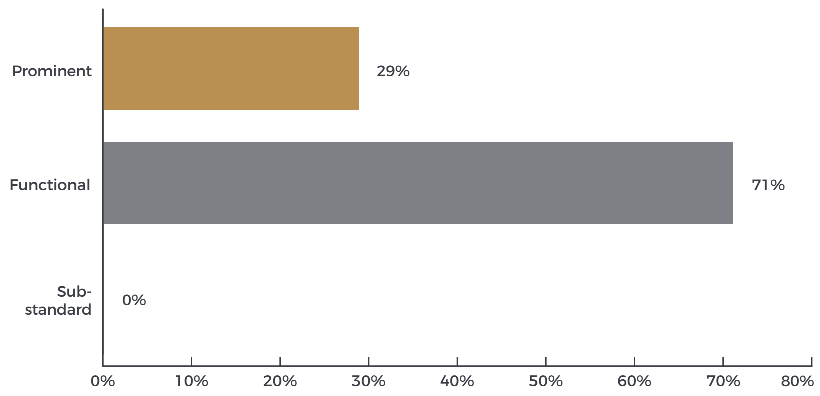
These managers typically provide portfolio-level information either weekly or monthly. However, they deploy risk-management tools (e.g. proxy benchmarks) for the efficient management of the portfolio. There may be multiple data sources, but ownership, stewardship and other controls are in place to ensure their integrity.

'Sub-standard'

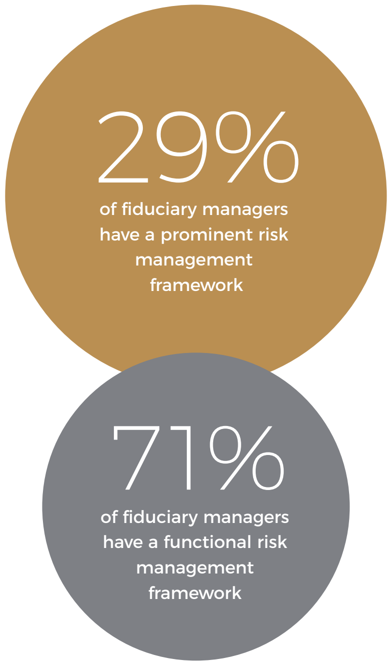
With these fiduciary managers, there are high levels of manual data manipulation and controls are fragmented.

6. Operational Risk Management

STANDARD OF FRAMEWORK



SOURCE: IC Select Research of the FM Universe



Operational risk management is the fiduciary manager's framework for the identification, monitoring and resolution of operational risk. The firm's attitude and approach to risk awareness and culture across the business is also captured here.

Transparency is important. Firms with a strong risk management culture are typically more willing to disclose data relating to breaches, compensation and audits.

Strong operational risk management benefits long-term performance by driving process improvement and reducing the risk of process flaws or inappropriate or inadvertent client exposures going undetected.

DEFINITIONS

'Prominent'

These fiduciary managers present strong evidence of a commitment to and investment in a firm-wide culture of awareness and training in relation to risk and regulation. Generally, they will have clean SOC reports or at least low levels of exceptions with robust management responses. Pre- and post-trade compliance is extensive, systemic and clearly segregated. They will have clear reporting lines and display a proactive, collaborative approach to risk, counterparty, and liquidity management. They are open and cooperative in sharing information.

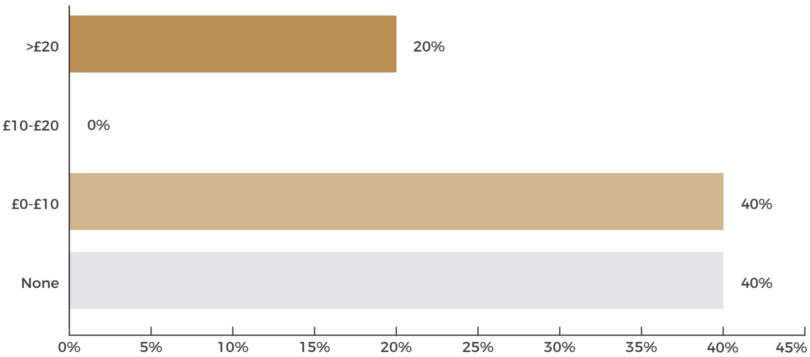
'Functional'

Risk management practices at these fiduciary managers are appropriate, but their tools may be manual and/or it may be unclear how they maintain a consistency of approach across the business. Control reports may contain recurring minor exceptions. Processes around counterparty selection and management may be unclear. Their attitude to information sharing is inconsistent.

'Sub-standard'

Here, there is little or no independent oversight in capturing and reporting risk events. The segregation of roles and responsibilities is inadequate. SOC reports are either not completed, unavailable or contain significant exceptions. These managers are reluctant to disclose detailed information.

COMPENSATION PAID PER MILLION OF AUM



SOURCE: IC Select Research of the FM Universe

69% of fiduciary managers declined to disclose client compensation payments

20% of those disclosing paid compensation greater than £20 per £1m of assets under management

Analysing the levels of compensation paid to clients is an effective way to monitor and benchmark the efficiency of a fiduciary manager's operational controls.

Compensation payments are typically small in relation to assets under management. However, where payments are high and remain elevated for several years, it is often a signal that there are underlying problems at the manager.

Persistent errors, whether they be in trading, settlement or corporate actions, erode an organisation's reputation in the market. Disclosing compensation increases confidence in a manager and facilitates a dialogue that improves processes.

Two thirds of managers will still not disclose this information. The primary reason they give is that the information is confidential. However, a growing number now feel that this information is pertinent to their clients and are happy to disclose it. Given the increased emphasis on transparency, clients should expect their fiduciary manager to provide it.

Information relating to compensation for errors is highly relevant to all clients of a fiduciary manager and those pension schemes considering appointing a fiduciary manager. Trustees should be concerned about those fiduciary managers that fail to disclose this information and should bear it in mind at the time of appointment.

It is possible that their reluctance to disclose means that their compensation payments are particularly high and suggests that there are failings within the organisation.

The transparency of those managers that do disclose this information is welcome. It enables clients, in subsequent discussions with these managers, to gain reassuring insights into how they have responded to operationally related incidents and strengthened their operating models to avoid problems happening again.

Last year, 80% of managers who disclosed the information either made small compensation payments or did not have to pay compensation at all.

However, 20% of managers paid compensation of more than £20 per £1 million of assets under management.

Statement of Operational (SOC) Report Analysis

SOC reports, produced by organisations who are independent of the fiduciary management firm, are a particularly effective way for trustees to assess and monitor the suitability of their fiduciary manager.

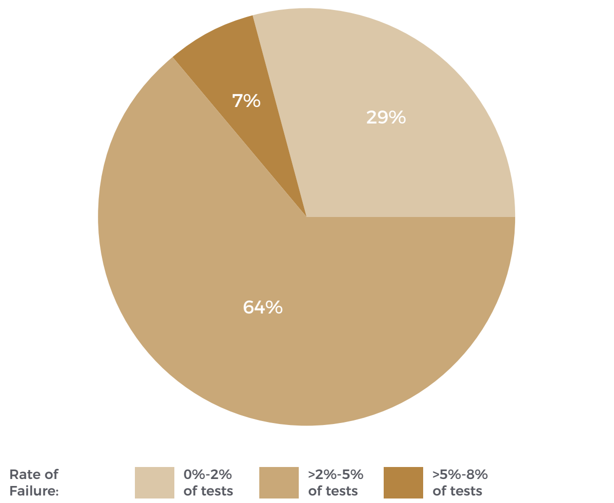
The objective of the SOC report is to provide reasonable assurance about the processes that are in place to safeguard assets, including areas such as reconciliations, transaction processing and account management. The reports also aim to provide reasonable assurance on the reliability of financial records for maintaining accountability for the assets. The report should give an indication of the fiduciary manager's attitude to operational risk and management of processes within its control.

Our assessment of SOC reports traditionally covers three main areas: scope, qualifications and exceptions and trend analysis.

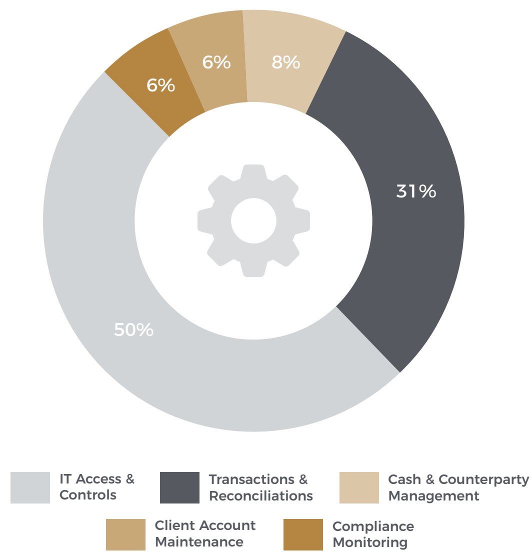
However, the scope of SOC reports has improved significantly in recent years and now includes the full range of services offered by all fiduciary managers. As a result, we have excluded the scope of SOC reports from this survey.

Qualifications & Exceptions

RELATIVE TO NUMBER OF TESTS



SHARE BY OPERATIONAL CONTROL AREA



SOURCE: IC Select Research of the FM Universe

Qualifications and exceptions are the isolated instances of operational failures that are picked up during the tests carried out which are integral to the process of preparing a SOC report.

We have calculated the number of these incidents as a percentage of the tests carried out in order to make them comparable between managers. Some 29% of managers failed fewer than 2% of tests and 64% of managers failed between 2% and 5%. However, 7% of managers failed more than 5% of tests.

Exactly half (or 50%) of the qualifications and exceptions in the SOC reports were related to IT access and control. These are most commonly related to delays or omissions in restricting systems access for employees who have transferred internally or left the firm. The next most common area for qualifications and exceptions was transactions and reconciliations.

7%

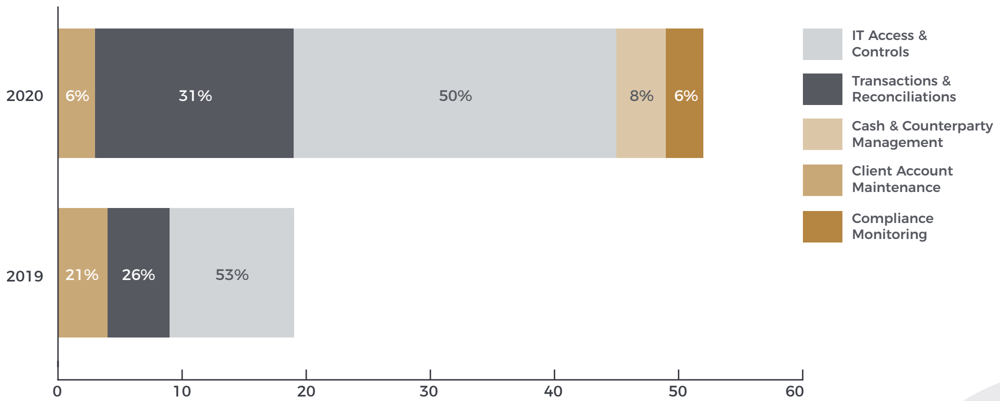
of fiduciary managers failed more than 5% of their tests

IT ACCESS & CONTROL

was the most common area for qualification & exceptions

Trend Analysis

QUALIFICATIONS & EXCEPTIONS BY OPERATIONAL CONTROL AREA



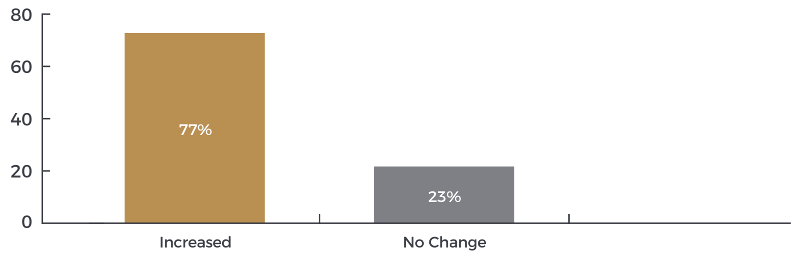
SOURCE: IC Select Research of the FM Universe

It is not uncommon for an organisation to have qualifications and exceptions in its SOC report. The identification of errors and their correction is one of the key benefits of producing them. What is concerning, however, is when an organisation repeats the same error in subsequent years. Between 2019 and 2020, only one manager reported the same qualification and exception, this has been the case for this manager for three consecutive reports.

3x

One manager has had the same qualification & exception for 3 consecutive reports

CHANGE IN QUALIFICATIONS & EXCEPTIONS: 2019 vs. 2020



SOURCE: IC Select Research of the FM Universe

174%

increase in qualifications & exceptions between 2019 & 2020

77%

of managers had an increase in the number of qualifications & exceptions

Covid-19 created significant challenges for managers in their operations because of the rapid move to working from home. Typically, managers assured their clients that the process had been seamless. However, between 2019 and 2020 there was a 174% increase in the number of qualifications and exceptions reported in firms' SOC reports, with 77% of managers having an increase. This suggests that the transition to home working was not as straightforward as had been reported.