

REGIONAL MUNICIPALITY OF OTTAWA-CARLETON
MUNICIPALITÉ RÉGIONALE D'OTTAWA-CARLETON

REPORT
RAPPORT

Our File/N/Réf.
Your File/V/Réf.

DATE 14 March 1997

TO/DEST. Co-ordinator
Corporate Services and Economic Development Committee

FROM/EXP. Finance Commissioner

SUBJECT/OBJET **CONTRACT AWARD**
INVESTMENTS - CUSTODY SERVICES

DEPARTMENTAL RECOMMENDATION

That the Corporate Services and Economic Development Committee and Council approve the award of a contract to Royal Bank of Canada to provide custody services, including safekeeping, trade settlement services and securities lending services for a two year period at an estimated annual cost of \$31,600.

BACKGROUND

As at December 31, 1996 the Region held investments of approximately \$475 million for various reserve funds and for the Region's Sinking Fund Committee. These investments include short term money market instruments, (\$205 million) such as Government of Canada Treasury Bills, Provincial and Municipal notes, bankers acceptances and overnight investments. The balance is held in long term investments (\$196 million on behalf of the Sinking Fund Committee and \$74 million on behalf of various reserve funds) including Government of Canada and Provincial bonds and municipal debentures including RMOC issues. The size of the Sinking Fund will increase over the next few years to approximately \$275 million through levies and reinvestment of earnings to meet existing Sinking Fund debt obligations. Reserve Fund investments are expected to fluctuate as funds are required to meet expenditure needs but are expected to remain at or near current levels.

At the present time investments are held in a variety of forms and with various financial institutions. For many years, the Region received certificates for its investments which were held in a safety deposit box at a local bank branch. The administration of these investments requires staff to frequently visit the bank to deposit new investment certificates, obtain interest coupons and to retrieve the certificate on maturity for the redemption of principal by depositing it with a bank. In addition, a proper accounting and portfolio management reporting system is maintained.

As industry practices have changed over time, most new bond issues are now being made through a central depository and investors are generally unable to receive certificates but hold the investments in "book based" form. Rather than issuing thousands of certificates and administering the many re-registrations over the life of the issue, typically one certificate is provided to the depository which holds it on behalf of its members and maintains a record of the amount each member investment firm or bank holds of that issue at any point in time. The Region has taken advantage of these savings in its last two debenture issues launched in the domestic market which were issued in "book based" form through CDS. When investing funds, the Region purchases "book based" investments through an investment dealer or bank which holds the investment on the Region's behalf.

In making investment decisions staff obtain quotes from various firms to obtain the most attractive quote. At the present time the Region has twenty-two accounts with a number of investment firms and banks. The administration of book based investments requires staff to reconcile each dealer statement to Regional records, deliver and pick up cheques for new investments and principal maturities which involves frequent follow up to obtain payments promptly.

DISCUSSION

A request for proposals was prepared in December 1996 indicating the Region's requirements for custody services. In recent years there has been a consolidation in the custody business in Canada and six experienced financial institutions were invited to submit proposals. Proposals were received from the following:

- Royal Bank of Canada/ Royal Trust Corporation of Canada
- Bank of Montreal Trust Company
- Canada Trust
- CIBC Mellon Global Securities Services
- Montreal Trust (Royal Trust)
- National Bank of Canada

The Royal Trust Corporation of Canada was acquired by the Royal Bank of Canada in September 1993 and since then the custody operations of each organization have been gradually integrated together. Custody Service contractual arrangements may be entered into with either organization. Since the request for proposals was issued, Royal Trust has announced an agreement to acquire the institutional and pension custody and related business of Montreal Trust and Scotiabank.

Objectives

The purpose of obtaining custody services is to establish a more efficient and cost effective administration of the Region's investment portfolios while maintaining the secure safekeeping of all investments. The Region has the following specific objectives:

- Eliminate the daily practice of issuing and delivering cheques for investment purchases as well as the pick up and deposit of cheques for investment maturities by making and receiving all payments through a custodian.
- Eliminate the requirement for a safety deposit box and frequent visits by staff to pick up and deposit investment certificates.
- Reduce the administrative problems related to missing or incorrect settlement instructions resulting from communication difficulties between institutional trading desks in Toronto and local offices.
- Improve the use of cash within the portfolios by consolidating all investments with one custodian thus reducing the administration requirements to transfer funds amongst institutions and follow up late interest payments on investments as well as to reconcile dealer statements.
- Increase competitive pricing when the Region identifies an opportunity to sell one investment and purchase another. With "book based" investments it is impractical and costly to sell investments between dealers. With all investments held by one custodian, staff will be able to sell an investment to whichever firm offers the most attractive price.
- Enhance reporting capabilities through on-line access to portfolio reports and performance measurement against selected indices.
- Provide the potential to increase the return on investment portfolios by participating in a "securities lending" program.

Evaluation of Proposals

The proposals were evaluated based on a number of criteria including:

1. Costs for safekeeping and portfolio administration including custody fees, transaction costs and communication costs.
2. Experience of the institution in providing custody services as well as its overall financial strength.
3. Reporting systems available including types of reports, frequency and ability to customize reports.
4. Financial controls over trades entries, trade failures, movement of funds and assets under administration and participation in a recognized central depository for investments.
5. Administrative ease of using the custody system including the ability to integrate it with current banking arrangements with the Royal Bank of Canada.
6. Value added through securities lending services and interest earnings on free cash balances.

Results of Evaluation

Annex A attached summarizes the evaluation of each proposal received. On the basis of this evaluation proposals from Royal Bank of Canada/Royal Trust Corporation of Canada, Canada Trust and Bank of Montreal were short listed for further consideration.

It became apparent during the review that all three short listed proponents could meet the Region's expectations for custody services in terms of custody arrangements, controls and safekeeping of investments and the accuracy of record keeping and trade settlements. However no system was available from these suppliers which could completely replace the combination of software and spreadsheets which are being used for accounting, reporting and portfolio management purposes.

The Royal Bank/Royal Trust Corporation of Canada was selected on the basis of overall cost, experience in the custody business, ease of working with our banking arrangements and ability to provide securities lending services.

A custody service arrangement with Royal Bank meets the objectives set out for considering custody arrangements with the exception of enhanced reporting capabilities and performance measurement. As mentioned above, no system is available from any of the short listed suppliers at a reasonable cost which would replace the existing information system consisting of an accounting and portfolio management software package and various spreadsheets. However, data files may be transferred electronically from the Royal Bank which will facilitate the preparation of existing reports on the systems currently in place.

Although the opportunity of receiving various performance measurement reports from a custodian is attractive, the cost of this service relative to the reporting available from the preferred supplier does not support the additional expenditure of \$10,000 annually. Instead other alternatives will be investigated including the introduction of reports prepared internally based on downloaded files.

Securities Lending

Securities Lending offers a potential revenue source to the Region by lending investment securities from the Region's portfolio to financial institutions, typically investment firms, which would like to borrow these securities for a period of time. This activity is normally managed through custodians who will select borrowers, evaluate and monitor their creditworthiness and arrange for acceptable collateral. The types of fixed income investments normally borrowed are highly liquid Government of Canada Treasury Bills and bonds and certain provincial bonds. A dealer will borrow securities when it finds it has very little of a specific well traded security in its inventory, and to facilitate trading strategies. The custodian will arrange delivery of the "borrowed" securities, ensure collateral is received, collect the revenue on the borrowed securities and distribute the revenue between itself and the lender(s) on a previously agreed to basis. The risk of default is mitigated by the collateral received (normally 105% of the value of the securities borrowed) and the screening of the borrower by the custodian. In addition the lender may receive "enhanced" indemnification from the custodian against losses arising from the failure by the borrower to return securities as well as any losses resulting from the custodian's own negligence.

Securities lending has been actively practised in Canada for over ten years. Bill 165 which was given Royal Assent on June 25, 1992 allowed Ontario Regional Governments and Municipalities to lend *securities held by it if the loan is fully secured by cash or other securities described in subsection 163(2) or clause 167 (2) (a)*. The Region of Peel and The Regional Municipality of Hamilton-Wentworth are known to participate in securities lending programs. In 1991 the Office of the Superintendent of Financial Institutions (OSFI) issued guidelines related to the practise of securities lending by federally regulated financial institutions.

Entering into a securities lending agreement does not guarantee revenue as the type and frequency of securities on loan will depend on the investments held in the portfolio, and market conditions. The Region is proposing to enter into a securities lending agreement with The Royal Bank of Canada on an enhanced indemnification basis which would involve a revenue sharing arrangement of 40% to RMOC and 60% to Royal Bank. Based on the current portfolios, it is estimated that such a program will generate net revenue of \$12,000 to \$16,800 annually.

EXPENDITURE JUSTIFICATION

Placing the Region's investments with a custodian will greatly enhance the efficiency of the administration of the investment portfolios. The actual costs to be eliminated are minimal however, the reduced time spent on administrative matters is significant. Further more improved utilization of cash balances and the potential enhanced returns on sales of investments are expected to generate additional revenue. The estimated annual benefits of custody services to the Region are as follows:

	\$
Savings for eliminating safety deposit box and cheque processing	1,200
Staff time redirected from daily banking activities, dealer statement reconciliation, safety deposit box, collection of securities	15,000
	\$
Improved utilization of cash balances	3,500
Enhanced yields on investment sales	14,000
Net Securities lending revenue	<u>16,800</u>
	50,500
Less estimated annual cost of Custody Services	<u>31,600</u>
<u>Estimated Net Benefit</u>	<u>18,900</u>

CONSULTATION

The public consultation process is not applicable.

FINANCIAL STATEMENT

Funds are available in the 1997 Operating Budget Account 012-18630-8930 Bank Service Costs.

*Approved by
J. C. LeBelle*

GM
Attach.

EVALUATION CRITERIA	ROYAL TRUST/ ROYAL BANK	CANADA TRUST	BANK OF MONTREAL	CIBC MELLON	MONTREAL TRUST <i>(acquired by Royal Trust)</i>	NATIONAL BANK
ESTIMATED ANNUAL COST	\$31,600	\$34,500	\$57,400	\$80,000	\$58,400	\$39,900
EXPERIENCE	<ul style="list-style-type: none"> - dominant in Canada & recognized internationally - Aa2 (Moody's) - \$522 billion assets in custody 	<ul style="list-style-type: none"> - in trust business for 100+ years - AA (low) by DBRS - \$183 billion pension & institutional assets under admin. 	<ul style="list-style-type: none"> - 100+ years in trust line of business - AA- (S & P) - \$145 billion assets in custody 	<ul style="list-style-type: none"> - 100 years in this line of business - Aa3 (Moody's) - \$131 billion assets in custody 	<ul style="list-style-type: none"> - 100 years in trust business - AA - \$200 billion in assets in custody 	<ul style="list-style-type: none"> - A1 (Moody's) - \$22 billion in assets in institutional custody accounts
TRADE PROCESSING & OPERATIONS	<ul style="list-style-type: none"> - on line entry through their system - ability to assign different access & authority levels - systems compatible with Region's banking arrangements - current software DOS based, new software in development 	<ul style="list-style-type: none"> - transfer funds to/from bank accounts at no charge - very good software provided 	<ul style="list-style-type: none"> - on line entry, real time processing - ability to assign different access & authority levels - able to set compliance standards - transfer of funds between bank and custodian at no charge. 	<ul style="list-style-type: none"> - on line entry, real time multi-currency processing - Windows based software 	<ul style="list-style-type: none"> - fax or outside electronic link recommended to provide transaction data 	<ul style="list-style-type: none"> - fax or electronic link to provide trade data
REPORTS & STATEMENTS	<ul style="list-style-type: none"> - data can be downloaded to Excel software - present report quality, fair - limited analytical functions - many reports available on line, hard copy within 30 days of month end 	<ul style="list-style-type: none"> - monthly reports available within 6 days - good quality reports - data can be downloaded to Excel - customized reports available 	<ul style="list-style-type: none"> - customized reports available - reports available on-line, hard copies within 10 days of month end. - good quality reports - data files can be downloaded to Excel 	<ul style="list-style-type: none"> - reports available on-line, hard copies within 7 days of month end. - good quality reports - data files can be downloaded to Excel 	<ul style="list-style-type: none"> - reports available on-line, hard copies within 10 days of month end. - good quality reports - data files can be downloaded to Excel 	<ul style="list-style-type: none"> - reports available on-line, hard copies within 2 days of month end. - data files can be downloaded to Excel

EVALUATION CRITERIA	ROYAL TRUST/ ROYAL BANK	CANADA TRUST	BANK OF MONTREAL	CIBC MELLON	MONTREAL TRUST <i>(acquired by Royal Trust)</i>	NATIONAL BANK
SECURITIES LENDING	<ul style="list-style-type: none"> - long established securities lender - full indemnification available - \$22 billion in loans outstanding daily - RMOC can approve borrower and collateral - adhere to OSFI guidelines 	<ul style="list-style-type: none"> - basic indemnification only - \$8 billion in loans outstanding daily - RMOC can approve borrowers and collateral - adhere to OSFI guidelines 	<ul style="list-style-type: none"> - full indemnification available - \$6 billion outstanding in loans daily - RMOC can approve borrowers & collateral - adhere to OSFI guidelines 	<ul style="list-style-type: none"> - adhere to OSFI guidelines - participant in Cnd. market since 1985 - \$40 billion in lendable assets 	<ul style="list-style-type: none"> - adhere to OSFI guidelines 	<ul style="list-style-type: none"> - \$4 billion in loans outstanding daily - limited collateral accepted - enhanced indemnification available
PERFORMANCE MEASUREMENT	<ul style="list-style-type: none"> - hard copy available quarterly - many indices used 	<ul style="list-style-type: none"> - monthly reports and more in-depth report quarterly - many indices 	<ul style="list-style-type: none"> - monthly reports - many indices used 	<ul style="list-style-type: none"> - monthly reports - multiple indices 		<ul style="list-style-type: none"> - only 4 indices available