4 National Pensions Reserve Fund

4.1 The National Pensions Reserve Fund (NPRF or the Fund) was established in 2001 with the objective of providing a fund of money to meet a portion of the future costs of social welfare and public service pensions. An independent National Pensions Reserve Fund Commission (the Commission) was established to control and manage the NPRF. The functions of the Commission include

- determining the investment strategy for the Fund, implementation of that strategy and control, management and investment of the assets of the Fund in accordance with the Fund investment strategy
- the appointment of investment managers and custodians for the Fund.

4.2 The National Pensions Reserve Fund Act, 2000 (the Act) requires the Commission to appoint a manager, through which it performs its functions and to which it may delegate functions. The National Treasury Management Agency (NTMA) was appointed manager in 2001 for a period of 10 years and was reappointed, with the approval of the Minister for Finance, in 2011 for a period of five years. As manager of the Fund, the NTMA procures services including specialist investment managers, transition managers and the global custodian to carry out certain functions on behalf of the Commission.

4.3 This chapter reviews

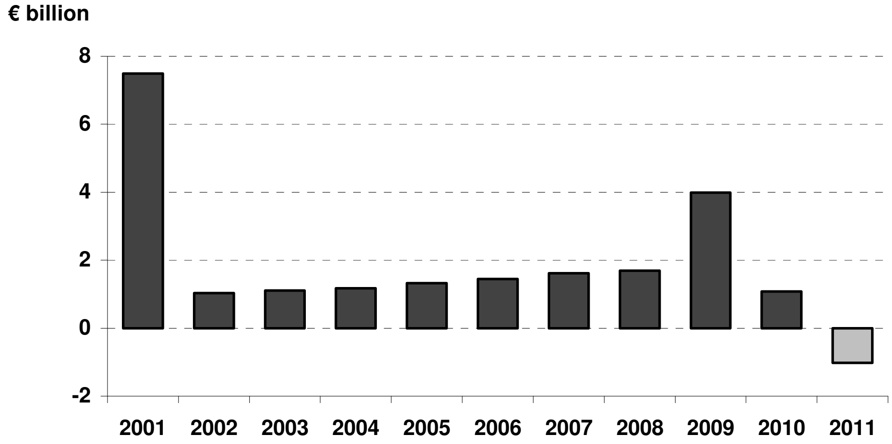
- the change in value in the NPRF in 2011 and
- payments for transition manager services provided by one of the managers appointed by the NTMA to liquidate NPRF assets during a portfolio restructuring during 2011.

Contributions to the Fund

4.4 The Exchequer annual contribution to the Fund, in accordance with the Act, is 1% of Gross National Product. During 2009, €3 billion was contributed to the Fund for the purposes of recapitalising Bank of Ireland and Allied Irish Banks. During 2009 and 2010, the pension fund assets of six universities and ten non-commercial semi-state bodies totalling €2.1 billion were transferred to the NPRF. These payments of €5.1 billion met the funding for the Exchequer contribution to the Fund for the years 2009 to 2011. In 2011, on direction of the Minister, the Commission transferred €1 billion from the Fund to the Exchequer. The Credit Institutions (Stabilisation) Act 2010 provides that the Minister may order that no contribution be paid into the Fund in 2012 and 2013.

4.5 Figure 4.1 sets out the contributions to and withdrawals from the Fund since its establishment, including assets transferred from pension schemes.

Figure 4.1 Exchequer Contributions to/Withdrawals from the NPRF 2001 to 2011



Source: National Pensions Reserve Fund Financial Statements

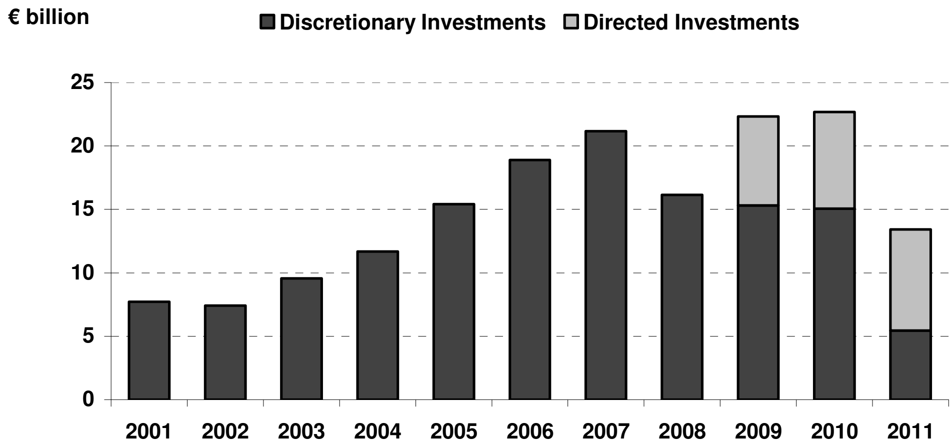
Value of the NPRF

4.6 The NPRF holds two types of investments

- Discretionary investments whereby investments are controlled and managed by the Commission in accordance with the NPRF's investment policy as defined in the Act and with an investment strategy determined by the Commission.
- Directed investments whereby the Minister may direct the Commission to invest in credit institutions or to underwrite share issues in those institutions.[1] The Minister may also direct the Commission with regard to the management and disposal of any such investments.

4.7 The value of the Fund for the period 2001 to 2011 is set out in Figure 4.2.

Figure 4.2 Value and composition of NPRF at year end 2001 to 2011



Source: National Pensions Reserve Fund Financial Statements

Note: Cash was transferred from the discretionary investments to fund the acquisition of directed investments as follows: 2009 - €4 billion; 2010 - €3.7 billion; 2011 - €10 billion.

1 These powers were given to the Minister in the Investment of the National Pensions Reserve Fund and Miscellaneous Provisions Act 2009.

4.8 The value of the NPRF stood at €13.4 billion at 31 December 2011. This comprised discretionary investments of €5.4 billion and directed investments of €8.0 billion, valued on a fair value basis. Figure 4.3 sets out the movement in the NPRF for the year ended 31 December 2011.

Figure 4.3 Movement in the Value of the NPRF 2010 and 2011

	2010	2011
	€m	€m
Value of the NPRF at 1 January	22,336	22,687
Movements in year		
Assets transferred from pension schemes	1,079	1
Income and gains on discretionary investments	1,824	181
Income from directed investments	1,192	469
Loss on directed investments	(3,721)	(8,903)
Taxation and administration costs	(23)	(2)
Withdrawal by the Exchequer	—-	(1,018)
Value of the NPRF at 31 December	22,687	13,415
Of which		
▪ discretionary investments	15,060	5,453
▪ directed investments	7,627	7,962

Source: National Pensions Reserve Fund

4.9 At the end of 2010, the value of the discretionary portfolio was €15.06 billion. In February and April 2011, the Minister issued directions to the Commission to hold a total of €10 billion in cash or debt instruments.[2] The Minister stated that the purpose of the directions was to facilitate a proposed contribution of €10 billion from the NPRF to the EU/IMF programme of financial support for Ireland.

4.10 On foot of these directions from the Minister, the Commission liquidated assets from its discretionary portfolio to the value of €5.5 billion in March 2011 and €4.5 billion in April 2011. Following these transactions, the value of the discretionary portfolio was €5.32 billion. This had increased to €5.45 billion by the end of 2011. The discretionary portfolio earned a return of 2.1% in 2011.

Investments in Banks

4.11 In July 2011, under directions from the Minister, the Commission invested the €10 billion that had been raised from the disposal of assets in the discretionary portfolio in Allied Irish Banks plc (AIB) and Bank of Ireland.

4.12 The total investment in the two banks, including reinvestment of dividends received in the form of ordinary shares in the period 2009 to 2011, and following the disposal of shares in Bank of Ireland was €20.59 billion. By the end of 2011, the value of the investments had fallen to €7.96 billion. At 31 December 2011, 59% (2010: 34%) of the NPRF's resources were devoted to capitalisation of Irish banks. The key events in the Fund's investments are set out in Figure 4.4.

2 It was a requirement that such instruments be issued or guaranteed by Eurozone governments and be rated AA or better with a maturity in 2012.

Figure 4.4 Summary of NPRF Investments in Bank of Ireland and Allied Irish Banks plc

Date	Key investment events	Cost
	Bank of Ireland	**€m**
March 2009	Preference shares	3,500
February 2010	Dividend on preference paid in ordinary shares	250
April 2010	Conversion of €1.66 billion preference shares to ordinary shares	__
July 2011	Purchase of ordinary shares[a]	1,229
July 2011	Sale of ordinary shares[b]	(1,052)
	Total investment at cost at December 2011	**3,927**
	Allied Irish Banks plc	
March 2009	Preference shares	3,500
May 2010	Dividend on preference shares paid in ordinary shares	280
December 2010	Ordinary shares[c]	3,818
April 2011	Conversion of convertible non-voting shares to ordinary shares	-
May/July 2011	Dividend on preference shares paid in ordinary shares	289
July 2011	Purchase of ordinary shares	5,000
July 2011	Capital contribution	3,771
	Total investment at cost at December 2011	**16,658**

Source: National Pensions Reserve Fund

Notes: a This is the amount net of underwriting and other fees received by the NPRF.

b This is the proceeds before transaction fees paid by the NPRF.

c 675 million ordinary shares and 10,489 million convertible non-voting shares were acquired in December 2010. The net cash invested was €3,700 million following receipt of €118 million in cash from fees and the sale of equity warrants (see Figure 4.5).

4.13 At the end of 2010, the NPRF held 36% of the ordinary shares in Bank of Ireland. In 2011, the Commission, under direction of the Minister, underwrote a rights issue by Bank of Ireland and took up the rights attaching to its shareholding at a total cost of €1.23 billion (10 cents per share) bringing its total investment in Bank of Ireland to €4.98 billion. Following the investment, the NPRF held just over 15 billion ordinary shares in Bank of Ireland at an average cost of 20.9 cents each.

4.14 On 24 July 2011, the Minister directed the Commission to sell part of its shareholding in Bank of Ireland following the rights issue to a group of institutional shareholders for €1,052 million. The net proceeds of the sale, which amounted to €1,018 million after costs of €34 million were deducted, were remitted to the Exchequer on the direction of the Minister. Following the disposal, the NPRF held 15.1% of the ordinary share capital in Bank of Ireland.

4.15 At the end of 2010, the NPRF held 49.9% of the ordinary shares in AIB as well as 10.5 billion convertible non-voting shares which were converted into ordinary shares in April 2011. As a result, it increased its holding of ordinary shares from 49.9% to 92.8%.

4.16 In May and July 2011, AIB paid the dividend due on the Fund's preference shares in the form of ordinary shares and the NPRF received over 1.2 billion ordinary shares. This included a penalty for late payment as the full dividend was payable in May. The value of the shares issued was €289 million.

4.17 In July 2011, the Commission, under direction of the Minister, invested a further €5 billion by purchasing 500 billion ordinary shares at a price of €0.01 per share and also made a capital contribution of €3.77 billion. This contribution did not entitle the NPRF to any shares in AIB. Following this transaction, the NPRF's holding was 512.6 billion shares, amounting to 99.8% of AIB's ordinary share capital.

Return on Investments

4.18 During 2009, 2010 and 2011, the NPRF received income and gains of just under €1.8 billion from its investment in the institutions, comprising cash and non cash elements, as set out in Figure 4.5. Cash receipts amounted to €936 million.

Figure 4.5 Income and Gains on Investments 2009 to 2011

Income and gains	**Bank of Ireland**	**Allied Irish Banks**	**Total**
	€m	**€m**	**€m**
Transaction fees	94.2	95.9	190.1
Cancellation of preference share warrants[a]	478.9	52.5	531.4
Dividends on Preference Shares			
- paid in the form of ordinary shares	250.4	569.0	819.4
- paid in cash	214.4	—	214.4
Total	**1,037.9**	**717.4**	**1,755.3**

Note: a Issued in 2009 in conjunction with preference share purchases.

4.19 In the first half of 2012, the NPRF received dividends on its preference shares as follows

- On 20 February 2012, Bank of Ireland paid a dividend due of €188.3 million in cash.
- On 14 May 2012, AIB paid the dividend due (€280 million) in the form of ordinary shares. Based on the market value of 7.7 cents per share, the NPRF received just over 3.6 billion shares.

Valuation of Directed Investments

4.20 In its financial statements for the year ended 31 December 2009, the Commission valued the directed investments at cost under a direction of the Minister. From 31 December 2010 onwards, having sought and received a revised direction from the Minister, the Commission valued the directed investments at fair value in line with Irish generally accepted accounting principles (GAAP).

4.21 As the preference shares held as part of the directed investments are not quoted on the market (unlisted and not traded), the NTMA, on behalf of the Commission, engaged Goodbody Corporate Finance to provide independent valuation advice on the fair value of the NPRF's holdings as at 31 December 2011. That valuation resulted in the Fund's financial statements indicating that

- The preference shares in Bank of Ireland increased marginally in value during 2011 to €1.47 billion (2010: €1.46 billion). This is around 20% below their value when they were acquired in 2009.
- The preference shares in AIB increased in value by around 8% to €2.22 billion (2010: €2.05 billion), around 37% below their value when they were acquired in 2009.

4.22 The fair value of ordinary shares is generally the closing market price on the primary exchange or market where they are quoted. For Bank of Ireland ordinary shares, the market price at 31 December 2011 was taken as the fair value of the shares.[3]

4.23 The Commission decided that as the NPRF holds almost all of the shares in AIB, the market price of the remaining shares is not a reliable indicator of fair value due to the low level of shares traded. Consequently, for the holdings in AIB ordinary shares at year end, the assessment of the fair value was based on independent valuation advice, provided by Goodbody and based on GAAP, which concluded that their fair value was 0.76 cents per share.

4.24 At the end of 2011, the NPRF had invested almost €20.6 billion in the two banks net of the proceeds of share disposals in Bank of Ireland (see Figure 4.6). At that date

- the value of the investments was just under €8 billion – a fall in value of just over €12.6 billion
- the NPRF had received income, gains and proceeds from the sale of warrants totalling €1,755 million.

Figure 4.6 NPRF Directed Investments – Summary at 31 December 2011

	Bank of Ireland	Allied Irish Banks Plc	Total
	€m	€m	€m
Investment at cost	*4,979*	*16,658*	*21,637*
Disposals	*(1,052)*	—	*(1,052)*
Net investment cost	3,927	16,658	20,585
Valuation of shares	1,843	6,119	7,962
Decline in value to December 2011	*2,084*	*10,539*	*12,623*
Income, gains and sale of warrants	1,038	717	1,755
Net decline in value to December 2011	*1,046*	*9,822*	*10,868*

Source: National Pensions Reserve Fund

3 By the end of June 2012, the value of ordinary shares in Bank of Ireland had increased by 22% from 8.2 cents to 10.0 cents.

Conclusions – Value of the NPRF

4.25 The National Pensions Reserve Fund (NPRF) was valued at €13.4 billion at the end of 2011 – a decrease of €9.3 billion (41%) from the 2010 valuation. €1 billion of the reduction was due to the withdrawal of monies from the Fund by the Minister.

4.26 At the end of 2011, the NPRF held 41% of its assets in its discretionary portfolio. These are the investments that are controlled and managed by the Commission in accordance with an investment policy defined in the Act and with a strategy determined by the Commission itself. The balance of the assets was invested in Irish financial institutions under directions from the Minister for Finance. The discretionary portfolio earned a return of 2.1% in 2011.

4.27 The main development in 2011 was the transfer of €10 billion from the discretionary portfolio for further investment in Allied Irish Banks and Bank of Ireland. This transfer formed part of the EU/IMF programme of financial support for Ireland.

4.28 Following that 2011 investment and the disposal of shares to the value of €1 billion in Bank of Ireland (the proceeds of which were remitted to the Exchequer), the NPRF has invested a total of €20.6 billion in the two banks. The investment includes €0.8 billion of dividends received in shares in the two banks. By the end of 2011, the value of the investment had fallen by 61% to just under €8 billion. When income, gains and sales of warrants of €1,755 million are taken into account, the net write down is €10.9 billion or 53% of the investment.

Payment for Transition Manager Services

4.29 On behalf of the Commission, the NTMA, as manager of the Fund, appoints a range of service providers to manage Fund assets and to undertake necessary transactions. The main services are depicted in Figure 4.7.

4.30 In 2007, the NTMA created a panel of three transition managers following a tender competition conducted under EU procurement rules and operating under a framework agreement. When it needs to carry out a transition, it conducts restricted tender competitions in which the firms from the transition manager panel are invited to tender.

Transition Number 14

4.31 As required under the 2010 EU/IMF Programme of Financial Support for Ireland and having received directions from the Minister, the Commission took steps to have €10 billion in Fund assets readily available for investment on receipt of further directions from the Minister. The Commission planned to meet some of its commitment from its cash resources, but required other assets to the value of around €6.8 billion, across a range of asset classes, to be liquidated.

4.32 In December 2010, the NTMA awarded contracts, following a restricted tender competition, to two firms from the transition manager panel to manage the transition (transition number 14) on its behalf. One transition contract was awarded to London-based State Street Bank Europe Ltd (SSBE), for the disposal of assets for a management fee based on the value of the assets disposed.[4] No other compensation, other than certain foreign exchange costs, was to be paid to SSBE.[5]

4.33 Between February and May 2011, SSBE disposed of NPRF assets to the value of €4.7 billion, and the fee payable under the contract amounted to €698,000.

Additional charges on transition number 14

4.34 In October 2011, the NTMA became aware through media reports that two senior executives, one based in the United Kingdom and one based in the United States, had departed from the transition team of SSBE. The NTMA requested further information from SSBE.

4.35 In response, on 12 October 2011, SSBE wrote to the NTMA explaining that it had reimbursed a UK client following the application of a commission that had not been expressly agreed with the client, had taken appropriate internal steps to guard against further occurrences of that nature and was conducting a comprehensive review of the small number of other transitions in Europe from earlier in 2011 in which it had agreed to apply a management fee only. One of the transitions being reviewed was the NPRF's transition 14.

4.36 On 28 October 2011, the NTMA wrote to SSBE informing it that, in the light of the ongoing SSBE review of other transitions, it was suspending SSBE from the NPRF transition manager panel. This suspension remains in place.

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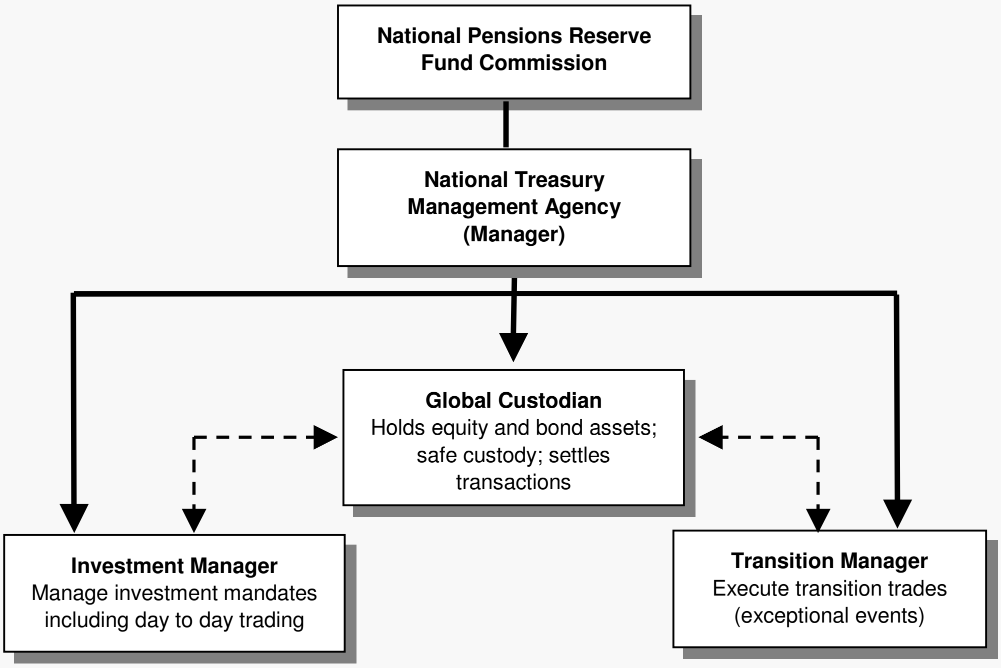
4 1.65 basis points (0.0165%) of the value of the majority of the assets, and 1.25 basis points (0.0125%) for the remainder.

5 State Street Bank Europe Ltd (SSBE) is authorised and regulated by the UK Financial Services Authority.

Figure 4.7 Services Contracted by NTMA for Management of Listed Equities and Bonds[a]



Global custodian role

The global custodian holds in safe custody securities and other assets in the ownership of the Fund. In addition, the global custodian has other functions including transaction settlement, collection of income and dividends on assets including the conversion of foreign currency receipts, claiming tax refunds, cash management, daily valuation of securities and provision of data to support the Fund's accounting and performance measurement functions.

Investment manager role

The Fund's strategic asset allocation is broken down for investment purposes into a number of investment mandates by type (e.g. equities) and by geographical location (e.g. Europe). The management of these mandates is outsourced to specialist investment management institutions (investment managers). Investment managers manage portfolios, including day-to-day trading, within guidelines and parameters set down by the Commission. At the end of 2011, the Fund was using the services of 11 investment managers.

Transition manager role

A transition refers to the restructuring of the Fund's portfolio, typically either when investment management passes to new firms, where there is a change in asset allocation strategy or where there are large injections or withdrawals from the discretionary portfolio that result in the need for significant trading in listed markets. The Fund engages transition managers to purchase or sell, on behalf of the Fund, the securities required or being disposed. A transition manager seeks to minimise the costs of market impact through careful timing of the execution of trades. In addition the transition manager co-ordinates all of the various participants involved including investment managers, the global custodian and NTMA. The purpose therefore of the arrangement is to enable the market risks, operational risks and costs incurred to be managed systematically.

Note: a Certain assets of the Fund are not managed through the arrangements set out in Figure 4.7 including property, private equity, commodities and hedge fund investments which are managed by third party managers and cash and some bond assets which are managed directly by the NTMA.

4.37 On 14 November 2011, SSBE wrote again to the NTMA stating that, following its review, it had concluded that a commission for which there was no contractual agreement had been applied to the NPRF transactions in transition number 14. In December 2011, SSBE paid the NPRF €2.65 million which was SSBE's estimate of the aggregate amount of the mark-ups applied.

4.38 In January 2012, SSBE informed the NTMA that a small number of its other clients in the UK also were charged fees that were not consistent with their contractual arrangements and that were not transparent to the client. PwC Boston was engaged by SSBE to independently review the fees, commission and spreads charged in respect of transition number 14 using a methodology that had been agreed by PwC with the NTMA. In March 2012, PwC reported that it had recalculated the charges and had concluded that the amount owed by SSBE was marginally lower, at €2.61 million, than the rebate paid to the NPRF. It had been agreed in advance with SSBE that the NPRF would not be required to make any repayment under these circumstances.

Basis of Trading

4.39 In its tender submission for transition number 14, SSBE stated that it would act as agent of the NPRF in relation to equity trading. The NTMA has stated that agency, rather than principal, trading represented a critical aspect in its evaluation of SSBE's tender submission and contributed to its final score in the tender evaluation. (Figure 4.8 explains the trading bases.) However, in July 2012, SSBE wrote to the NTMA reporting that, arising from a continued review of transitions undertaken in 2010 and 2011, it had determined that it had acted as a 'riskless principal' in connection with the liquidation of certain NPRF shares in transition number 14, which would be inconsistent with its duties as agent to NPRF, and that it had made a profit of around $787,000 on the transactions without taking any risk of loss. SSBE offered to repay this amount.[6]

4.40 On 21 August 2012, the NTMA wrote to SSBE noting that upon reviewing the matter, the Commission would accept SSBE's offer of a rebate of $787,279 but that this was subject to the understanding that acceptance of the payment was not a full and final settlement of the amount due to the NPRF and was without prejudice to its right to the conduct of a full investigation into the matter by an independent professional firm, to be paid for by SSBE, in order to confirm the amount due. On 24 August 2012, SSBE paid this amount to the Fund.

Earlier Transitions

4.41 The NTMA had 16 transitions carried out under the framework agreement. SSBE had previously been involved in two other NPRF transitions (numbers 3 and 4), both of which were carried out in 2009, and in light of the experience on transition number 14, the NTMA asked SSBE to review these.

4.42 On 23 February 2012, the NTMA received a letter of attestation from SSBE stating that its compliance department had conducted a review of the two transitions and had not found any issues with either. Following review of the supporting trade data for the transitions, the NTMA wrote to SSBE on 21 August 2012 raising an issue with the conclusions of the SSBE review in respect of transition number 4. This matter is the subject of ongoing engagement.

4.43 The NTMA has written to other transition managers contracted on behalf of the NPRF requesting confirmation that no unauthorised commissions have been applied in the course of any transitions managed on behalf of the NPRF.

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6 The profits of $787,000 amount to around €630,000 at 24 August 2012.

Reporting to Relevant Regulator

4.44 The UK Financial Services Authority (FSA) is the primary regulator of SSBE. The NTMA stated that, while neither it nor the Commission had any legal or regulatory obligation to inform the FSA about the charging issues that had arisen in relation to its dealings with SSBE, the Commission requested on 29 June 2012 that the FSA be notified. This was done on 7 August 2012 by the NTMA. SSBE had informed the NTMA in writing on 26 January 2012 that it had notified the FSA of the issue.

Figure 4.8 Selected Asset Trading Terms

Principal Trading

Principal trading (also called proprietary trading) occurs when a financial institution or broker (trading firm) trades on its own account rather than on behalf of a customer.

Agency Trading

Agency trading takes place when the trading firm trades on behalf of a client and the trading is governed by the terms of the contractual agreement between the client and the trading firm.

A risk that arises is that of a conflict of interest where a trading company carries out both proprietary trading and also acts as an agent for clients with gains that should accrue to the client being allocated instead to the benefit of the trading company.

Implementation Shortfall

Standard market practice is that the performance of a transition manager is measured by an 'implementation shortfall' outcome. This is calculated by measuring the difference between the performance of the transition manager in disposing of a transition portfolio over a period and what would hypothetically have been achieved if the portfolio had been sold instantly. Implementation shortfall represents the "all in" cost of trading and comprises bid/ask spread costs, market impact (e.g. the impact on price of disposing of a large portfolio) and explicit costs (e.g. taxes and commissions).

The implementation shortfall is estimated in advance of each transition and is expressed as a specific estimate (for example 20 basis points, 0.2%) together with a standard deviation (for example plus or minus 50 basis points, +/-0.5%).

The standard deviation of the implementation shortfall represents the normal expected variability in outcome around the central pre-trade estimate due to the risk arising from uncertain market conditions. Any outcome within plus or minus one standard deviation of the pre-trade estimate would be regarded as 'normal'.

Best Execution

Best execution refers to a broker's obligation to obtain the best trade for a customer taking into account price, costs, speed of execution, settlement and any other relevant factors.

Controls over Transition

4.45 The NTMA stated that it manages the inherent risks arising with transitions through

- using large regulated organisations of scale and substance as transition managers

- robust contractual terms with the transition managers, which include the ability to engage auditors to audit the books, accounts and other financial statements of the transition manager as they relate to services provided to the NPRF
- constant interaction with the transition manager and with the NPRF's global custodian during the days leading up to and during the transition, and
- comprehensive review of post transition results.

4.46 The transition managers are required to carry out transitions in conformity with framework agreements with the NTMA including a requirement to confirm annually policies in relation to trading, best execution and conflicts of interest and that there had been no material breaches of these policies. Because transitions occurred frequently, this confirmation was effectively obtained on the occasion of each tender competition when a transition manager confirmed in its tender response that there had not been any material adverse change to its business model, transition management product or capabilities, transition management performance, key people, systems or operational standards.

4.47 Standard market practice is that transition managers' performance is measured by the implementation shortfall outcome for each transition (see Figure 4.8). The NTMA reviews the prices reported by the transition managers in their implementation shortfall reports focusing, in particular, on explanations for variations in implementation shortfall as compared with the pre-trade estimate and with the pre-trade standard deviation. The NTMA stated that prior to the transition, SSBE had estimated that the implementation shortfall would be around 35 basis points (0.35%) with a standard deviation of ±73 basis points (0.73%), implying a 'normal' result would fall within the range of a gain of 38 basis points and a cost of 108 basis points. The implementation shortfall reported was 20 basis points. The additional commissions charged equated to 7 basis points, meaning the correct implementation shortfall should have been 13 basis points. The additional commissions charged (0.07%) were not material to the transition's overall financial outcome, which was below the pre-trade estimate, and which was well within the variability that might arise in a 'normal' markets scenario.

Proposed Actions

4.48 The NTMA stated that it is proposing to take additional steps to mitigate risks specifically associated with activities similar in nature to those encountered on transition number 14.

- The NTMA will seek to improve the visibility of transition agency trades on behalf of the Fund so as to ensure that any attempts at price manipulation would be discovered in the settlement process. Towards that end, instead of agency trades being settled through a broker account of the transition manager, they would be settled directly with the third party market counterparty. Such an arrangement would enable the Fund's global custodian to directly match the price of the trade with the market counterparty and therefore would prevent any improper alteration of trade price data within the transition manager organisation.
- On sizeable transitions, where it considers it cost effective to do so and where there is no reasonable alternative method of obtaining assurance in relation to trade prices and commission charges, the NTMA will engage the Fund's internal auditor to audit the books of the transition manager as they relate to the NPRF transition.
- The NTMA will, where feasible and practical, seek to promote the development of improved market standards and practices within the transition management industry with the objective of improving levels of transparency, third party transaction validation and general oversight.

Risk of incorrect charging by Investment Managers

4.49 Whereas transition managers undertake large-scale one-off trades on behalf of the NPRF, investment managers have responsibility for trades on an ongoing basis in the course of their management of investment mandates on behalf of the NPRF.

4.50 In relation to the risk of unauthorised charges occurring, the NTMA highlighted a number of points around the control of investment managers

- Trades by investment managers are advised to the global custodian and settled by them directly with a third party broker. This differs from standard market practice in transition management.
- All prices achieved by investment managers are submitted to a third party independent firm that monitors and analyses trading activity seeking to identify any instances where best execution may not have been achieved. The independent firm reports quarterly to the NTMA and identifies any instances where its analysis indicates that best execution may not have been achieved or where brokerage costs appear high.
- Each investment manager must provide quarterly statements from its compliance department that it has met the terms of its investment management agreement and must also provide annually a report from an external auditor that reports on the control environment related to investment management services including trade order and execution processes. The trade execution controls are audited to provide reasonable assurance that transactions are properly authorized, executed and allocated in a timely and accurate manner. Market practice to date has developed to the point that while such external auditor reports have become quite widely available in respect of investment managers, they are not yet generally provided in respect of transition managers.

Overview of Chief Executive

4.51 The NTMA's Chief Executive stated that transition management is a complex financial process requiring significant trading and markets expertise as well as technology and project management capabilities to co-ordinate and execute extremely large volumes of securities transactions. The Chief Executive pointed out that there have been significant economic benefits to the NPRF arising from the transition manager panel and that, in particular, use of transition managers has facilitated the liquidation at low cost and with minimal market impact of a very substantial proportion of assets to facilitate over €20 billion of the Fund's assets being available for investment as directed in AIB and Bank of Ireland. The NTMA manages the risks arising through robust contractual arrangements with regulated organisations of scale and substance and through constant interaction with the transition manager before, during and after the transition.

4.52 The NTMA expects the highest standards of probity from firms it engages and considers the Fund's experience in relation to transition number 14 to be entirely unacceptable.

4.53 In this case, the amendments improperly applied to trade data were never visible to the NTMA or to the global custodian. It would appear also that they were not identified by SSBE's internal controls or procedures or by its internal audit or compliance functions. The NTMA understands that the overcharging was discovered because a UK client of SSBE was able to identify that the sale price reported by the market in respect of specific trades of 'trace eligible' securities did not correspond with the price reported to it by SSBE.[7] None of the assets held by NPRF were 'trace eligible' and the NTMA could not have used this technique to discover the correct trade prices.

7 Certain securities traded by the client were 'trace eligible' US bonds – where the market standard is that individual trades are reported publicly in full detail.

4.54 SSBE has promptly repaid the NPRF in respect of transition number 14 and has implemented or agreed to implement arrangements to provide independent validation of the amounts repaid. In light of the experience on transition number 14, NTMA decided to conduct a further review of previous transitions carried out by SSBE for the NPRF. Arising from this review one further issue was identified as outlined at paragraph 4.42 above and discussions in this regard are ongoing.

4.55 In reviewing the issues that have arisen in respect of transition number 14, the NTMA has identified actions that it proposes to take, as set out in more detail in paragraph 4.48 above.

Conclusions and Recommendations – Payment for Transition Manager Services

4.56 In the course of 2011, the NPRF liquidated assets in order to meet its commitment to provide €10 billion under the EU/IMF Programme of Financial Support for Ireland. As part of that process, SSBE liquidated assets to the value of €4.7 billion for a management fee of €698,000. However, SSBE also applied commissions of €2.6 million for which there was no contractual agreement and also earned profits of €0.6 million on the sale of NPRF's holding in an index fund while acting as a principal but without taking any risk of loss.

4.57 SSBE has refunded the NPRF in respect of the unauthorised commissions and the principal trading profits.

4.58 While the additional charges represented a small percentage of the assets sold on behalf of the NPRF by SSBE (0.07%), the effect was to increase the amount earned by SSBE to over 5.5 times the contractual fee.

4.59 The NTMA carried out a post-transition review designed to gain assurance that the outturn from the transition was within its pre-transition estimates. The results of the post-transition review were satisfactory and were within the range expected. However, while implementation shortfall is a sound basis for benchmarking and evaluating the performance of transitions, its sensitivity for checking commission costs is questionable. Reliance on the internal controls of regulated service providers may not prevent or detect the application of unauthorized commissions or profit-taking on the disposal of NPRF holdings.

4.60 The NTMA should implement the steps it has proposed to mitigate the risks of overcharging by managers. In addition, the following are recommended

Recommendation 4.1: While having regard to the proposal to obtain post-transition compliance statements from transition managers, the NTMA should consider submitting the prices achieved by transition managers, perhaps on a random sample basis, to an independent third-party firm to review and report any instances where it appears that best execution may not have been achieved or where brokerage costs appear high.

Chief Executive's Response: The NTMA will consider this recommendation. However, in the context of the specific issues arising in respect of transition number 14, the NTMA believes that changing the operational structure of transitions as described above so that the Fund's global custodian matches transition trades directly with the third party counterparty would be more effective.

Recommendation 4.2: Review whether contracts should include terms for penalties to be payable to the NPRF, in addition to recompensing the NPRF for losses, in circumstances where a manager fails to fulfil a material contractual obligation.

Chief Executive's Response: The NTMA will carry out such a review. Our preliminary legal advice is that the Fund's entitlement to damages under existing framework agreements with transition managers together with general principles of contract law address this point and that imposing penalties in contracts that significantly exceed losses (and whose primary purpose is to deter a party against breach of contract) may not be enforceable subsequently by the courts.

Recommendation 4.3: Notwithstanding that it may not have a legal obligation to report certain matters to regulatory authorities, the Commission should, as a matter of policy, in instances of suspected failure to conduct business appropriately on the part of a firm it has engaged, promptly report such instances to the relevant regulatory authorities for their consideration.

Chief Executive's Response: The NTMA accepts this recommendation. It should be pointed out that on this occasion the Commission reported the matter to the relevant regulator even though no legal obligation existed.

Recommendation 4.4: The NTMA should review the usefulness of the implementation shortfall as the primary performance measure and control check in relation to the costs of transitions.

Chief Executive's Response: In relation to evaluating the overall performance of a transition, implementation shortfall is the market standard. As regards the specific issues raised by transition number 14, the NTMA will put in place the measures identified in 4.48 and those arising from addressing the C&AG's recommendations.