Notice of meeting and agenda

Pensions Audit Sub-Committee of the Pensions Committee

10.00am, Monday 16 December 2013

Dunedin Room, City Chambers, High Street, Edinburgh

This is a public meeting and members of the public are welcome to attend

Contact

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1. Order of business

1.1 Including any notices of motion and any other items of business submitted as urgent for consideration at the meeting.

2. Declaration of interests

2.1 Members of the Committee and members of the Consultative Panel should declare any financial and non-financial interests they have in the items of business for consideration, identifying the relevant agenda item and the nature of their interest.

3. Deputations

3.1 None

4. Minute

4.1 Pensions Audit Sub-Committee of the Pensions Committee 20 September 2013 (circulated) – submitted for approval as a correct record

5. Reports

5.1 Annual Report on the 2012/13 Audit of the Lothian Pension Funds – report by the Director of Corporate Governance (circulated)

5.2 Internal Audit Bi-Annual Activity Report – December 2013 - report by the Chief Internal Auditor (circulated)

5.3 Investment Strategy Update - report by the Director of Corporate Governance (circulated)

5.4 Global Custody Services Performance - report by the Director of Corporate Governance (circulated)

5.5 Class Actions- report by the Director of Corporate Governance (circulated)

5.6 EU Tax Claims - report by the Director of Corporate Governance (circulated)

5.7 Risk Management - report by the Director of Corporate Governance (circulated)

6. Agenda Planning

6.1 Agenda Planning December 2013 – by the Director of Corporate Governance (circulated)

7. Motions

7.1 If any

Carol Campbell

Head of Legal, Risk and Compliance

Committee Members

Councillors Rose (Convener), Bill Cook and Orr.

Information about the Pensions Audit Sub-Committee

The Pensions Audit Sub-Committee consists of 3 Councillors and its membership is appointed by the Pensions Committee. Two members of the Consultative Panel also attend although in a non-voting capacity.

The Pensions Audit Sub-Committee usually meets in the City Chambers on the High Street in Edinburgh. The meeting is open to all members of the public.

Further information

If you have any questions about the agenda or meeting arrangements, please contact Gavin King, Committee Services, City of Edinburgh Council, City Chambers, High Street, Edinburgh EH1 1YJ, Tel 0131 529 4239, e-mail gavin.king@edinburgh.gov.uk.

A copy of the agenda and papers for this meeting will be available for inspection prior to the meeting at the main reception office, City Chambers, High Street, Edinburgh.

The agenda, minutes and public reports for this meeting and all the main Council committees can be viewed online by going to www.edinburgh.gov.uk/cpol.

Item 4.1 - Minutes

Pensions Audit Sub-Committee

10.00am, Friday 20 September 2013

Present

Councillors Rose (Convener) and Bill Cook

Consultative Panel Members Present:

Eric Adair and Eric MacLennan.

1. Minute

Decision

To approve the minute of the Pensions Audit Sub-Committee of the Pensions Committee of 17 June 2013 as a correct record.

2. Lothian Pension Funds Annual Report 2013 Audited

Details were provided of the Lothian Pensions Funds Annual Report 2013 Audited and the External Auditor's report on the audit of the Annual Report for the year ended 31 March 2013 for the Lothian Pension Fund, the Lothian Buses Pension Fund and the Scottish Homes Pension Fund.

Stephen O'Hagen, Audit Scotland, was in attendance at the sub-committee.

Decision

1) To note the External Auditor's report on the audit of the Annual Report for the year ended 31 March 2013 for the Lothian Pension Fund, the Lothian Buses Pension Fund and the Scottish Homes Pension Fund.

2) To note the Lothian Pensions Funds Annual Report 2013 Audited

(Reference – report by the Director of Corporate Governance, submitted.)

3. Investment Income Review – Cross Border Withholding Tax

A benchmarking study had been carried out by KPMG into the effectiveness of the procedures in place to manage the tax exposure on the investment income of the Lothian Pension Fund and Lothian Buses Pension Fund. Details were provided on the effectiveness of those arrangements and how the recovery of tax on Spanish dividends could be improved.

Decision

1) To note the report and the action taken in response to the findings of the withholding tax benchmarking report.

2) To repeat the benchmarking of the investment income tax services provided by the custodian on a regular basis, with the findings reported to the Pensions Audit Sub-Committee.

(Reference – report by the Director of Corporate Governance, submitted.)

4. Irrecoverable Overpayments of Pensions

Details were provided of pension overpayment of £5,491.50 which had been written off.

Decision

To note the total value of pension overpayment of £5,491.50 written off between 1 April 2013 and 31 August 2013.

(Reference – report by the Director of Corporate Governance, submitted.)

5. Prevention of Fraudulent Pension Payments

Details were provided of the work undertaken by Lothian Pension Fund to prevent fraud including involvement in fraud prevention initiatives and the overall management of risk.

Decision

1) To note the work undertaken by Lothian pension Fund to prevent payment fraud.

2) To request that the audit plan arising from the internal audit of the Pensions Service is provided to a future meeting.

(Reference – report by the Director of Corporate Governance, submitted.)

6. Pensions Administration Data Quality

Information was provided on the ongoing work to enhance the quality of pension administration membership record data.

Decision

To welcome the actions noted in the report and resolve to review the effectiveness of data quality measures at a future meeting.

(Reference – report by the Director of Corporate Governance, submitted.)

7. Risk Management

The Sub-Committee were asked to scrutinise the summary of the risk register.

Decision

To note the Committee Risk Summary.

(Reference – report by the Director of Corporate Governance, submitted.)

Pensions Audit Sub-Committee

10am, Monday, 16 December 2013

Annual Report on the 2012/13 Audit of the Lothian Pension Funds

Item number	5.1
Report number	
Wards	All

Links

Coalition pledges	
Council outcomes	CO26
Single Outcome Agreement	

Alastair Maclean

Director of Corporate Governance

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Executive summary

Annual Report on the 2012/13 Audit of the Lothian Pension Funds

Summary

The purpose of this report is to present the Auditor's Annual Report on the 2012/13 Audit of the Lothian Pension Funds. The report from Audit Scotland is shown at Appendix 1. This includes commentary from the Investment & Pensions Manager on the planned management actions. The report will be presented to Committee by Stephen O'Hagan, Senior Audit Manager, Audit Scotland.

In addition to members of the Pensions Committee, Audit Scotland has also sent the report to the Controller of Audit and has advised that the report will be published on its web-site in due course.

Audit Scotland has already provided "an unqualified opinion that the financial statements (of the Lothian Pension Funds) give a true and fair view of the transactions of the funds during the year ended 31 March 2013, and of the amount and disposition at that date of their assets and liabilities".

The Fund will be preparing audit plans for internal and external audit work to be undertaken in the next financial year. It is proposed that these plans are developed in consultation with the Convener of the Pensions Audit Sub-Committee prior to consideration by the Pensions Committee in March 2014.

Recommendations

To recommend that the Committee should:-

1. Note the Annual Report on the 2012/13 Audit of the Lothian Pension Funds;

2. Note the Action Plan at Appendix B of the Report and seek appropriate updates on progress;

3. Agree that the plans for internal and external audit are developed in consultation with the Convener of the Pensions Audit Sub-Committee prior to consideration by the Pensions Committee in March 2014.

Measures of success

Planned management action in relation to the points raised by Audit Scotland is stated at Appendix B.

Financial impact

There are no financial implications arising directly from this report.

Equalities impact

There are no adverse equalities impacts arising from this report.

Sustainability impact

There are no adverse sustainability impacts arising from this report.

Consultation and engagement

The Consultative Panel for the Lothian Pension Funds, comprising employer and member representatives, is integral to the governance of the Funds.

Background reading / external references

Not applicable.

Links

Coalition pledges	
Council outcomes	CO26 – The Council engages with stakeholders and works in partnerships to improve services and deliver agreed objectives.
Single Outcome Agreement	
Appendices	Audit Scotland report on 2012/13 Audit of Lothian Pension Funds

Lothian Pension Funds

Annual report on the 2012/13 audit

AUDIT SCOTLAND

Prepared for City of Edinburgh Council as administering body for Lothian Pension Funds and the Controller of Audit

October 2013

Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000. It provides services to the Auditor General for Scotland and the Accounts Commission. Together they ensure that the Scottish Government and public sector bodies in Scotland are held to account for the proper, efficient and effective use of public funds.

Contents

Key messages

2012/13 audit findings

Financial Statements

We have given an unqualified opinion that the financial statements give a true and fair view of the transactions of the Funds during the year ended 31 March 2013, and of the amount and disposition at that date of their assets and liabilities.

Financial Position (Funding)

Triennial funding valuations were carried out by the Funds' actuary as at March 2011. Exhibit 1 summarises the movement in funding levels between triennial valuations.

Exhibit 1: Triennial valuation funding levels

Funds	Triennial Funding Level at 31 March 2011	Triennial Funding Level at 31 March 2008
Lothian Pension Fund	96%	85%
Lothian Buses	112%	95%
Scottish Homes	86%	86%

Source: Triennial funding valuations at 31 March 2008 and 2011

The results of the triennial valuation determines employer contribution rates required over the next three year period (2012/13 to 2014/15) to attain the objective of a fully funded scheme at a set future date. This valuation resulted in the rates for the major employers being set within the range 16.9% to 17.2% (2011/12: 18.3% to 21.8%).

The actuarial statement for the Funds at 31 March 2013, which has no immediate effect on employer contribution rates, reported reduced funding levels for Lothian Pension Fund (87%), Lothian Buses (103%) and Scottish Homes (85%).

Financial Position (Administration costs)

The Funds' actual expenditure compared to the approved budget disclosed an underspend of £1.305 million for the year to 31 March 2013, mainly due to an underspend of £1.302 million on investment managers fees.

Governance and accountability

Overall the council's governance arrangements for the Funds in 2012/13 were adequate. No material weaknesses in the accounting and internal control systems were identified during the audit.

Best Value, use of resources and performance

The Fund has not been subject to a Best Value review however, it is covered by the overall Best Value arrangements of the administering authority. A Best Value audit of City of Edinburgh Council was completed during 2012/13 with a report being submitted in May 2013. There were no specific observations relating to pension fund management.

Annual employer performance against the pension administration standards, as set out in the Pension Administration Strategy (PAS), has been consistently poor since their introduction three years ago. None of the five employer targets set out in the PAS were achieved in 2012/13. The implementation of the Employer On-line Portal resulted in a significant improvement in performance in the last quarter of 2012/13.

During 2012/13 the Funds achieved an annual return equal to or greater than their scheme specific benchmarks. Over the three years to 31 March 2013, the Lothian Pension Fund delivered the same performance as its investment strategy but failed to achieve its higher target return (i.e. in excess of the strategy).

Outlook

The current period is a challenging one for pension fund management. With the global economic outlook and the uncertainty in the financial markets there are particular problems for investment management and strategy. With investment performance key to the funding position of the Local Government Pension Scheme (LGPS) this uncertainty may impact on employer contributions in the medium term.

The Public Service Pensions Act received Royal Assent on 24 April 2013. The Act implements the key recommendations of Lord Hutton's Commission as follows:

- the end of final salary benefit arrangements with the introduction of the career average revalued earnings basis
- retirement age linked to state pension age
- cost control system to provide affordability and sustainability
- measures to strengthen governance
- the latest date for commencement of new schemes under the Act is 6 April 2015.

Proposed changes to the LGPS will impact on administrative workloads going forward as will any further severance activity by employers. Additionally auto enrolment requirements affect information requirements and administration arrangements. Actions such as the introduction of the employer on-line system resulted in an improved employer performance in the final quarter of 2012/13 which will help towards minimising the impact of increases in administrative workloads in the medium term.

The co-operation and assistance given to us by members of the Pension Committee, officers and staff of the Investment and Pensions Division is gratefully acknowledged.

Introduction

1. This report is the summary of our findings arising from the 2012/13 audit of Lothian Pension Funds. The nature and scope of the audit were outlined in the Audit Plan presented to the Pensions Committee on 13 March 2013, and follow the requirements of the Code of Audit Practice prepared by Audit Scotland in May 2011. The purpose of the annual audit report is to summarise the auditor's opinions (i.e. on the financial statements) and conclusions, and to report any significant issues arising. The report is divided into sections which reflect the public sector audit model.

2. Appendix B is an action plan setting out the high level risks we have identified from the audit. Officers have considered the issues and agreed to take the specific steps in the column headed "planned management action". We do not expect all risks to be eliminated or even minimised. What we expect is that those charged with governance understand the risks and have arrangements in place to manage these risks. The administering body should ensure that those charged with governance are satisfied with the proposed management action and have a mechanism in place to assess progress.

3. This report is addressed to City of Edinburgh Council as administering body for Lothian Pension Funds and the Controller of Audit. It should be made available to the public and other stakeholders where appropriate. Audit is an essential element of accountability and the process of public reporting. This report will be published on our website after consideration by those charged with governance.

4. The management of Lothian Pension Funds is responsible for preparing financial statements that show a true and fair view and for implementing appropriate internal control systems. Weaknesses or risks identified by auditors are only those which have come to their attention during their normal audit work, and may not be all that exist. Communication by auditors of matters arising from the audit of the financial statements or of risks or weaknesses does not absolve management from its responsibility to address the issues raised and to maintain an adequate system of control.

Financial statements

5. Audited bodies' financial statements are an essential part of accounting for their stewardship of the resources made available to them and their performance in the use of those resources.

6. Auditors are required to audit financial statements in accordance with the timescales set by Audit Scotland, which may be shorter than statutory requirements, and give an opinion on:
   - whether they give a true and fair view of the financial transactions of the Funds during the year ended 31 March 2013 and of the amount and disposition at that date of its assets and liabilities
   - whether they have been properly prepared in accordance with relevant legislation, the applicable accounting framework and other reporting requirements.

7. Auditors review and report on, as appropriate, other information published with the financial statements, including the sections titled Review of the Year, About the Funds and Investment and Financial Performance and the Governance Compliance Statement. This section summarises the results of our audit on the financial statements.

Audit opinion

8. We have given an unqualified opinion that the financial statements of Lothian Pension Funds for 2012/13 give a true and fair view of the financial transactions of the Funds during the year ended 31 March 2013 and of the amount and disposition at that date of its assets and liabilities.

Legality

9. Through our planned audit work we consider the legality of the Pension Fund's financial transactions. In addition the Pensions and Accounting Manager has confirmed that, to the best of his knowledge and belief, the financial transactions of the Pension Fund were in accordance with relevant legislation and regulations. There are no legality issues arising from our audit which require to be brought to the attention of those charged with governance.

Governance compliance statement

10. Regulation 27 of the Local Government Pension Schemes (Administration) (Scotland) Regulations 2008 (SSI 2008/228) requires that the administering authority prepare a Governance Compliance Statement stating where their arrangements complied with Scottish Ministers Guidance, and where they did not. Although the regulations allow for this statement to be referred to in the annual report, the Funds took the decision to include the full statement. We are satisfied that this statement covers the areas and levels of compliance required by the Scottish Government's guidance.

Annual report

11. The Scottish Government Guidance requires that the annual report for the Pension Fund incorporates the following:
    - the financial statements
    - a report about the management and financial performance of the Funds during the year
    - a report explaining the authority's investment policy and reviewing the performance during the year of the investments of each Fund, and a report of the arrangements made during the year for the administration of the Funds
    - a statement by the actuary of the level of funding disclosed by their valuation
    - a governance compliance statement, funding strategy statement, and statement of investment principles (or details of where these statements may be obtained)
    - the extent to which levels of performance set out in the pension administration strategy have been achieved
    - any other material which the authority considers appropriate.
12. We are satisfied that the report incorporates the above sections and that the other sections are consistent with the audited accounts.

Accounting issues

13. Local authority bodies in Scotland are required to follow the Code of Practice on Local Authority Accounting in the United Kingdom 2012/13 (the 2012 Code) and the Service Reporting Code of Practice 2012/13, supported by International Financial Reporting Standards (IFRSs). We are satisfied that the financial statements have been prepared in accordance with the 2012 Code requirements.

Accounts submission

14. The Fund's unaudited financial statements were submitted to the Controller of Audit prior to the deadline of 30 June 2013. This enabled us to conclude the audit and certify the financial statements by the target date of 30 September 2013.

Significant findings (ISA260)

15. During the course of the audit we identified a number of issues regarding the appropriateness of accounting policies or accounting estimates and judgements, the timing of transactions, the existence of material unusual transactions or the potential effect on the financial statements of any uncertainties. The key issues identified are detailed in the following paragraphs.
16. **Investment Management Expenses:** Investment management expenses disclosed in the Pension Fund Account and supporting notes do not fully reflect the fees charged. Fees relating to private equity funds are accounted for within 'changes in market value of investments' and 'investment income'. However, the calculation of the fees is a complex area, particularly in regard to pooled investment funds, and it is not always possible to separately

identify these fees. The CIPFA Code on Local Authority Accounting in the UK 2012/13 recommends that investment management expenses be shown as a separate item in the fund account and further analysed in a note. Consequently the current presentation does not fully comply with the Code. This matter does not relate solely to Lothian Pension Funds but also applies to other Pension Funds in Scotland.

Resolution: The Investment and Pensions Service Manager will aim to improve the transparency of management fees in accordance with CIPFA's stated requirements by consulting with CIPFA, other Local Authority Pension Funds, the Fund's investment managers and custodian.

17. **Employee Contributions-Lothian Pension Fund:** Officers compiled a reconciliation of the employee contributions received from the seven largest employers, comparing the expected amount per the pension administration system to the actual amounts received. The reconciliation indicated that contributions received were £117,993 more than anticipated with the largest overpayment being from Midlothian Council (£39,131). This equates to 0.34% of the contributions receivable by the Fund for the seven employers. Officers have confirmed that these should represent valid contributions and the reconciliation differences arose very largely due to delays in the notification of the entry of new members to the scheme.

18. **Change in Accounting Policy:** The results for the year ended 31 March 2012 have been restated to reflect a change in the accounting policy on income generated by unquoted private equity and infrastructure investments. Previously all distributions arising from these investments were treated as capital and included in the Fund accounts as a 'change in market value of investments'. The new policy splits distributions into capital and income elements with the latter being classed as 'investment income' in the Fund account. The new policy reflects the Fund's increasing investment in infrastructure which produces a significant part of its distributions as income. The effect of the change was to increase the prior year 'investment income' received by £6,547,000 and to reduce the prior year 'change in market value of investments' by the same amount. This restatement had no impact on the net assets of the Fund brought forward from 2011/12.

Presentational and monetary adjustments to the unaudited accounts

19. In line with International Standards on Auditing 260 *Communication of audit matters to those charged with governance*, we reported the conclusions of our audit to the Pensions Audit Sub-Committee on 20 September 2013 and to the Pensions Committee on 24 September 2013. The report was also noted by the City of Edinburgh Council at its meeting on 24 October 2013. A number of presentational adjustments were identified within the financial statements during the course of our audit. These were discussed with senior finance officers who agreed to amend the unaudited financial statements. No monetary adjustments were identified.

Financial position

20. Audited bodies are responsible for conducting their affairs and for putting in place proper arrangements to ensure that their financial position is soundly based.

21. Auditors consider whether audited bodies have established adequate arrangements and examine:
    - financial performance in the period under audit
    - compliance with any statutory financial requirements and financial targets
    - ability to meet known or contingent, statutory and other financial obligations
    - responses to developments which may have an impact on the financial position
    - financial plans for future periods.

22. These are key areas in the current economic circumstances. This section summarises the financial position and outlook for the Funds.

Financial results

23. The Funds' actual expenditure compared to the budget disclosed an underspend of £1.305 million for the year to 31 March 2013. The main areas of underspend were supplies and services (£0.132 million), investment managers fees (£1.302 million), employee costs (£0.071 million) and central support costs (£0.046 million).

24. Investment manager's fees are dependent on market values and on a performance element for some managers. The savings on investment manager fees mainly arose as a result of changes in fund management arrangements including the termination of active currency overlay contracts.

Funding position

25. The latest triennial valuation of the three Funds was completed at 31 March 2011. The results of the triennial valuation determines employer contribution rates required over the next three year period to attain the objective of a fully funded scheme at a set future date.

26. The results of the valuation are disclosed in Exhibit 2. The valuation discloses that Lothian Pension Fund actual funding level rose from 85% at the 2008 valuation to 96% at 2011. This valuation resulted in the rates for the major employers in Lothian Pension Fund being set for 2012/13 within the range 16.9% to 17.2% (2011/12: 18.3% to 21.8%). Lothian Buses Pension Fund funding level rose from 95.5% to 112.4% and Scottish Homes Pension Fund showed a slight increase from 85.9% to 86.3%.

Exhibit 2: Movement in valuations 2008 to 2013

Fund Details	31 March 2008* £'m	31 March 2011* £'m	31 March 2013** £'m
Lothian Pension Fund			
Assets	2,903	3,477	4,095
Liabilities	3,427	3,619	4,707
Net Liability	(524)	(142)	(612)
Funding Level	85%	96%	87%
Lothian Buses Fund			
Assets	199	257	312
Liabilities	208	229	303
Net Asset / (Liability)	(9)	28	9
Funding Level	96%	112%	103%
Scottish Homes Fund			
Assets	126	124	140
Liabilities	147	144	165
Net Asset / (Liability)	(21)	(20)	(25)
Funding Level	86%	86%	85%

*Sources: * Triennial Valuations reports 2008 and 2011; ** Projected figures based on year end net assets value and funding level identified in 2012/13 actuarial statement for each fund*

27. In accordance with accounting standard IAS 26 'Accounting and Reporting by Retirement Benefit Plans' the present value of promised retirement benefits (actuarial value) is disclosed by way of a note to the Pension Funds financial statements. This liability is projected using a roll forward approximation from the latest formal funding valuation at 31 March 2011. Exhibit 2 includes these figures for each Pension Fund at 31 March 2013. The figures are only prepared for the purposes of the accounts and are not relevant for calculations undertaken for funding purposes and setting contributions payable to the Funds.

28. The Lothian Pension Fund (funding level of 87%) and Lothian Buses (funding level of 103%) have fallen. The present value of promised retirement benefits for Lothian Pension Fund rose by £761 million in 2012/13 mainly as a result of a change in assumptions used by the actuary which increased the actuarial present value liability by £482 million.

Membership

29. During the year overall membership of the Lothian Pension Fund increased from 66,354 to 69,888 per Exhibit 3. One of the key changes of the Pensions Act 2011 was the introduction of auto enrolment. To ensure the Pension Fund is auto enrolment compliant the Pension Fund membership was opened to casual workers. The inclusion of these workers explains the increase in Pension Fund membership in 2012/13. Active members increased by 441 and pensioners increased by 1,564.The total number of members retiring early was 686 of which 271 (2011/12: 607) related to members retiring as a result of employers offering Voluntary Early Release Arrangements (VERA).

Exhibit 3: Membership at 31 March 2013 - Lothian Pension Fund

Status	Membership at 31 March 2011	Membership at 31 March 2012	Membership at 31 March 2013
Active	28,919	28,337	28,778
Deferred	15,218	15,392	16,577
Pensioners	17,894	18,905	20,469
Dependants	3,682	3,720	4,064
Total	**65,713**	**66,354**	**69,888**

Source: Audited Financial Statements

30. The Funds have recognised the significant impact of the early release programmes in the Funding Strategy Statement which states that "the Fund shall undertake a regular review of its investment strategy to ensure appropriate alignment with its liabilities. Employer covenant and membership maturity profile reflecting any decision to close the Scheme to new entrants are both risk factors which may impact on liabilities and therefore will be taken into account by the Fund in its review of investment strategy."

31. The Funds are liaising with Hymans Robertson to explore the feasibility of developing a financial model to provide greater insight into cash flow forecasting as the Lothian Pension Fund is expected to move from net positive cash flows from dealings with members to a negative position. In the short term, as Fund maturity increases, investment income will be required to pay pension benefits. The sale of assets may be required to pay pension benefits but the Fund's actuary has advised that this not likely to happen for a number of years.

32. Cash flow monitoring reports are prepared monthly to ensure that sufficient cash balances are held to meet on-going pension commitments, and that any excess balances are passed periodically to the Fund’s investment portfolios. These cash flow reports are submitted to management and a summary is reported to the Investment Strategy Panel.

Outlook

2013/14 budget

33. The 2013/14 annual budget for administration costs is £13.49 million, an increase of £0.19 million from 2012/13. The most significant increases are:
    - employee costs (£0.25m) as result of two new posts (bond manager and solicitor / risk manager) plus three transferred posts in respect of the new pension payroll
    - third party payments (£0.24 million) offset by a reduction in support costs of £0.15 million due to the transfer of the pension payroll function to the LPF.

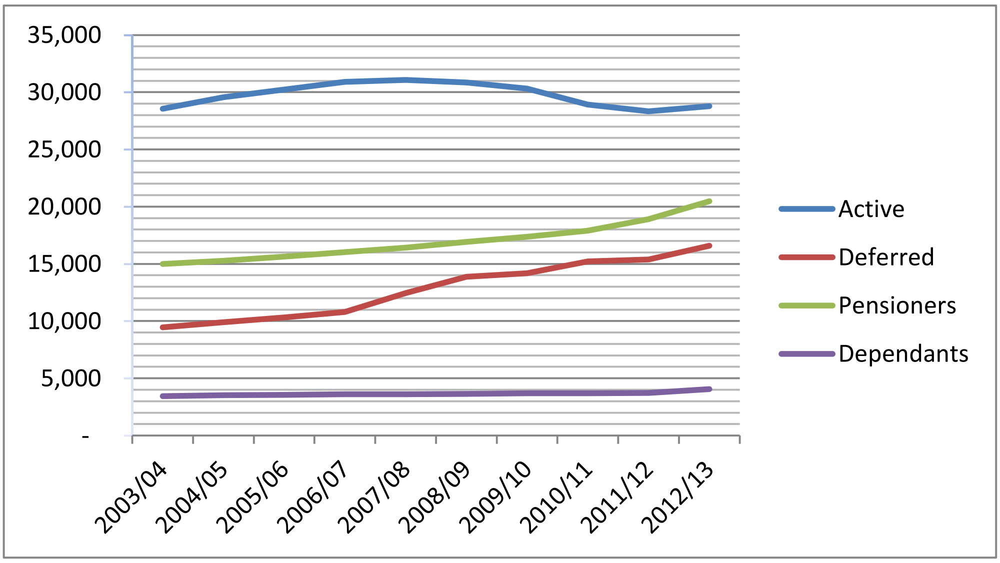
34. The Service Plan progress report presented to the September 2013 Pensions Committee projects an underspend of £0.43 million, mainly as a result of a reduction in investment managers fees.

Forecasts beyond 2013/14

35. Looking ahead, it is clear that the outlook for public spending for the period 2013/14 to 2015/16 remains very challenging. There are a number of ongoing developments in the public sector pension environment that could have a significant impact on the operation of local government pension schemes.

36. As a result of widespread severance schemes and recruitment freezes across participating employer bodies, it is likely that the membership profile of the fund will increasingly have a higher proportion of pensioner members compared to active members. Exhibit 4 tracks the movements on membership for the last 10 years which shows a convergence between active members and deferred / pensioner members.

Exhibit 4: Membership of Lothian Pension Fund for 10 years to 31 March 2013



Source: Lothian Pension Funds Annual Reports

37. Auto enrolment may lessen the impact on the profile of the Fund. At some point in the future the increase in pensioner numbers will result in monthly income not being sufficient to meet the Fund's monthly commitments, requiring the use of investment income to pay pension benefits. This has been considered as part of the Fund's review of its Investment strategy highlighted in paragraph 30 and 31.

Refer Action Point no. 1

Governance and accountability

38. The three fundamental principles of governance – openness, integrity and accountability – apply to all audited bodies, whether their members are elected or appointed, or whether they comprise groups of people or an individual accountable officer.

39. Through its chief executive or accountable officer, each body is responsible for establishing arrangements for ensuring the proper conduct of its affairs including the legality of activities and transactions, and for monitoring the adequacy and effectiveness of these arrangements. Audited bodies usually involve those charged with governance (including audit committees or similar groups) in monitoring these arrangements.

40. Consistent with the wider scope of public audit, auditors have a responsibility to review and report on audited bodies' governance arrangements as they relate to:

- governance and systems of internal control
- the prevention and detection of fraud and irregularity
- standards of conduct and arrangements for the prevention and detection of corruption.

41. In this part of the report we comment on key areas of governance.

Corporate governance

Processes and committees

42. As the administering authority, City of Edinburgh Council has statutory responsibility for the administration of the Funds. Its functions are carried out in accordance with the Local Government Pension Scheme (Scotland) Regulations 1998 and the Superannuation Act 1972.

43. Responsibility for the overall strategic direction of the Funds is delegated by the council to the Pensions Committee (the committee) which is comprised of elected members of the council and employer and member representatives. This replaced the Pensions and Trusts Committee in December 2012 as part of the overall review of governance arrangements in the council.

44. The committee meets quarterly to consider Pension Fund matters including reports on investment monitoring, budget monitoring and service plans. The committee's current membership consists of five councillors, one member representative and one employer representative with a quorum of three.

45. A Pensions Audit Sub-Committee consisting of 3 members was established in 2012/13 and is responsible for the audit scrutiny of the Pension Funds. The sub-committee reports to the Pensions Committee. The auditor's ISA260 report and proposed audit opinion were all reported to members of this committee. It is expected to meet three times per year and should

cover issues relating to financial statements, internal and external audit and risk control framework.

46. The Consultative Panel is the main mechanism for engagement with the Funds' stakeholders and enables their involvement in the decision-making process. The panel meets quarterly on the same cycle as the committee. Two members of the panel are also members of the Pensions Committee.

47. Day to day administration of the Fund is carried out by the Investment and Pensions Division which is part of the council's Corporate Governance department. The Head of Finance serves as the Section 95 Officer for all of the council's accounting arrangements, including those of the Lothian Pension Funds. For the Lothian Pension Funds, however, this Section 95 responsibility has been delegated to the Pensions and Accounting Manager.

Governance Compliance Statement

48. Pension Funds are required to produce a governance compliance statement, setting out areas where it does and does not comply with guidance issued by the Scottish Government on committee governance arrangements. The guidance covers membership of the pension committee, frequency of meetings, training of members and several other areas. The governance compliance statement produced by the Funds meets the requirements of this guidance.

Annual Governance Statement/Governance Compliance Statement

49. The Fund's financial statements currently include a Governance Compliance Statement and an Annual Governance Statement. The Code of Practice on Local Authority Accounting in the UK (the Code) does not require an Annual Governance Statement to be included in the financial statements. Guidance issued for the 2012/13 financial statements indicated that a single statement, covering key areas, is preferable. However, this is an area currently under consideration by CIPFA/LASAAC and it is likely that further guidance will be issued clarifying expectations in this area.

Internal Audit

50. Internal Audit holds a key role in the authority's governance arrangements, providing an independent appraisal service to management by reviewing and evaluating the effectiveness of the internal control system. The Fund's internal audit service is provided by the City of Edinburgh's internal audit function. Following a change in the arrangements in 2012/13, PricewaterhouseCoopers provide the internal audit function for the council and Pension Fund on a co-sourcing basis.

51. Our review of internal audit was conducted as part of the audit of the City of Edinburgh Council. The review found that the work is conducted in accordance with CIPFA's Code of Practice for Internal Audit in Local Government and we were generally able to place reliance on their work for the 2012/13 audit. The level of sample selection used by Internal Audit was below that requested by external audit. For those areas (transfers in and out and pension

payments) additional samples were selected and tested by external audit during the financial statements audit.

Internal control

52. While auditors concentrate on significant systems and key controls in support of the opinion on the financial statements, their wider responsibilities require them to consider the financial systems and controls of audited bodies as a whole. However, the extent of this work should also be informed by their assessment of risk and the activities of internal audit. As part of our work, we took assurance from key controls within the Fund's systems, with some controls being tested by internal audit. No significant control weaknesses were identified during this work.

53. The Fund's financial systems are run alongside those of the City of Edinburgh Council and some of its systems are used by the Investments and Pensions Division. We obtained confirmation from the external auditors of the council that there were no significant weaknesses in the internal controls for those systems utilised by the Investments and Pensions Division for 2012/13.

Prevention and detection of fraud and irregularities

54. Audited bodies are responsible for establishing arrangements to prevent and detect fraud and other irregularity. Auditors review and report on these arrangements. The Funds have arrangements in place to prevent and detect fraud, corruption and inappropriate conduct. These arrangements include standing orders and financial regulations, a whistle blowing policy, an anti-fraud and corruption policy and codes of conduct for elected members and staff. We have concluded that the arrangements in Lothian Pension Funds are satisfactory and we are not aware of any specific issues that we need to identify in this report.

NFI in Scotland

55. Audit Scotland has co-ordinated another major counter-fraud exercise working together with a range of Scottish public bodies, external auditors and the Audit Commission to identify fraud and error. These exercises, known as the National Fraud Initiative in Scotland (NFI), are undertaken every two years as part of the statutory audits of the participating bodies. The latest round of NFI commenced in June 2012, and will look to expand the range of data sets and bodies.

56. The NFI works by using data matching to compare a range of information held on bodies' systems to identify potential inconsistencies or circumstances that could indicate fraud or error which are called 'matches'. Where matches are identified these are made available to bodies to investigate via a secure web application. Bodies investigate these and record appropriate outcomes based on their investigations.

57. As part of our local audit work we monitor the council's approach to participation in NFI both in terms of the submission of the required datasets and strategies for investigating the subsequent data matches. For the council, internal audit plays a key role in co-ordinating the

investigation of matches with priority given to 'recommended matches' (i.e. indication of higher risk). Service departments are responsible for investigating matches within their area of remit.

58. With regard to pension matches being investigated by the Investment and Pensions Division, there were 1,086 from the most recent NFI data matching exercise. Of these, 330 were 'recommended matches'. These matches identify people who are in receipt of a pension but also appear on DWP and registrars records as being deceased, or who appear on another payroll system. The latest report summary in September 2013 indicates that, so far, 99 cases have been investigated and 15 are still being investigated. The Investment and Pensions Division intend to review all 'recommended matches' and expect to have this work completed by the end of March 2014. We will continue to monitor progress.

Standards of conduct & arrangements for the prevention / detection of bribery & corruption

59. Audited bodies are responsible for ensuring that their affairs are managed in accordance with proper standards of conduct and have proper arrangements in place for implementing and monitoring compliance with standards and codes of conduct, standing orders and financial instructions. Auditors consider whether bodies have adequate arrangements in place. Overall we concluded that arrangements are adequate and there are no issues that we require to include in this report.

Pension reform agenda

60. The Public Service Pensions Act received Royal Assent on 24 April 2013. The Act implements the key recommendations of Lord Hutton's Commission as follows:

- the end of final salary benefit arrangements with the introduction of the career average revalued basis
- retirement age linked to state pension age
- cost control system to provide affordability and sustainability
- measures to strengthen governance
- The latest date for commencement of new schemes under the Act is 6 April 2015.

61. The proposed changes to the LGPS will impact on administrative workloads going forward as will any further severance activity by employers. Auto enrolment requirements will also affect information requirements and administration arrangements. The Funds' Pensions Administration Strategy sets out standards for exchange of information, including the requirement for the employer to keep the Fund informed about planned changes to their pension provision including bulk transfers of staff and any outsourcing. The Fund engages with employers on a regular basis as follows:

- monthly bulletins are issued to employer contacts highlighting relevant issues
- employer events are held throughout the year
- by providing dedicated resource in the form of an Employer Relations Officer

62. The changes to relevant regulations and policies and the implications of these changes are communicated to employers, with consultation exercises carried out where appropriate.

Outlook

63. There are on-going developments that may have a significant impact on the form and operation of local government pension schemes. For example, the full extent of the recommendations made in the Hutton report and how they impact upon pension schemes in Scotland remains uncertain. Other Government initiatives, including workplace pension reforms and the creation of single Police and Fire Services, are also likely to have an impact on operational processes.

64. Auto-enrolment is now being implemented across employers who are members of the Funds. This will inevitably have an impact on administrative workloads, and early preparation for the changes is required to ensure continuing compliance with guidance. We will continue to keep this are under review in 2013/14.

65. The Funds should ensure that they prepared for the introduction of career average pensions. There will be a requirement to maintain pension records for each individual that will bring together a range of entitlements arising from benefits built up under different pension regimes. This will increase administrative workload initially, and there is a likelihood that there will be more queries and enquiries from Fund members seeking clarification on benefits.

66. We will continue to monitor the Funds' arrangements for dealing with these changes and any potential risks that arise.

Best Value, use of resources and performance

67. Audited bodies have a specific responsibility to ensure that arrangements have been made to secure Best Value.

68. Auditors of local government bodies also have a responsibility to review and report on the arrangements that specified audited bodies have made to prepare and publish performance information in accordance with directions issued by the Accounts Commission.

69. As part of their statutory responsibilities, the Accounts Commission may procure, through Audit Scotland, examinations of the use of resources by audited bodies and publish reports or guidance. Auditors may be requested from time to time to participate in:

- a performance audit which may result in the publication of a national report
- an examination of the implications of a particular topic or performance audit for an audited body at local level
- a review of a body's response to national recommendations.

70. Auditors may also consider the use of resources in services or functions, where the need for this is identified through local audit risk assessments.

71. During the course of their audit appointment auditors should also consider and report on progress made by audited bodies in implementing the recommendations arising from reviews in earlier years.

72. This section includes a commentary on the Best Value and performance management arrangements within the Pension Fund. We also note any headline performance outcomes/ measures used by the members and any comment on any relevant national reports and the body's response to these.

Management arrangements

Best Value

73. The Pension Fund has not been subject to a Best Value review however, it is covered by the overall Best Value arrangements of the administering authority. A Best Value audit of City of Edinburgh Council was completed during 2012/13 with a report being submitted in May 2013. The report focussed on the two judgements at the centre of the current Best Value audit approach:

- how well the council is performing in relation to services and outcomes. On this the report assessed the council's overall performance as "good"
- the council's prospects for future improvement, based on leadership and management, partnership working and resource use. Because many of the changes the council has

made are relatively recent and improvements are required in key aspects of Best Value, the report concluded that the council has "fair" prospects for improvement

74. The audit focused on the council and there is no expected impact on the Investments and Pensions Division. The Commission has asked the Controller of Audit to report on the council's progress in around eighteen months' time, from May 2013. The full report can be found on Audit Scotland's website: www.audit-scotland.gov.uk

Investment Performance

75. Investment advice and support is provided to the Fund by its Investment Strategy Panel (ISP) which is comprised of investment advisers and senior officers. The role of the ISP includes the development of investment strategy and the monitoring of the Funds' investments.

76. To ensure value for money is obtained the Funds carry out a structured procurement process which includes the consideration of fees. In addition the managers are monitored and their performance discussed at regular meetings. The results of the monitoring are reported to the Investment Strategy Panel. Fund management arrangements were reviewed during 2012/13 for Lothian Pension Fund resulting in the termination of active currency overlay contracts.

77. At the year end, an annual report on overall investment performance and activity is produced and reported to committee. A summary of investment performance for each Fund has been included in Exhibit 5.

Exhibit 5: Annualised Returns to 31 March 2013 (% per year)

Fund	1 Year Bench mark	1 Year Actual return	3 Year Bench mark	3 Year Actual return	10 Year Bench mark	10 Year Actual return
Lothian	13.9%	13.9%	8.1%	8.1%	9.5%	10.3%
Lothian Buses	13.8%	16.4%	8.7%	10.4%	10.1%	11.3%
Scottish Homes*	13.0%	13.0%	11.1%	11.2%	8.8%*	8.8%*

** Based on return from July 2005, inception date*

Source: Audited Financial Statements 2012/13

78. Over the three years to 31 March 2013, the Lothian Pension Fund delivered the same performance as its investment strategy but failed to achieve its higher target return which is in excess of the strategy.

79. Following the review of the investment strategy in 2012, the indicator for the investment performance of the Lothian Pension Fund has been amended. The target of outperforming the benchmark by 1% has been removed and replaced with a target of delivering benchmark return over the long-term with lower volatility of returns.

80. The Investment and Pensions Division reviewed the investment strategies of all their Pension Funds following the 2011 actuarial valuations. The review concluded that there was scope to

reduce the investment risk over the next few years and increase the focus on investment income to reduce returns volatility over the coming years. For Lothian Pension Fund and Lothian Buses Pension Fund the implementation of the new strategies involves increasing the amount of assets managed by the internal team. This work is progressing and is expected to be completed in the coming months. For Scottish Homes, the proportion of Funds invested in equities was reduced from 40% to 35% to reduce the risk in-line with the new investment strategy.

81. We note that this change in investment strategy for Lothian Pension Fund and Lothian Buses means that decisions by the Investment Strategy Panel and the internal investment team will influence the Funds' return to a greater extent, once the new strategies are in place. The Pensions Division is assessing the risks of these changes and we will consider the conclusions and the actions taken by the Pension's division to mitigate, manage and monitor any additional risks from the new strategies.

Administration Performance

82. The Funds' Administration Strategy was approved by the Pensions and Trusts Committee in March 2010 and was reviewed in 2012/13. It contains the standards which are required of the participating employers to ensure that the Fund meets its statutory obligations and is able to deliver services efficiently. The strategy contains a variety of performance measures against which the Fund and the participating employers are assessed.

83. In accordance with Regulation 60A of the LGPS (Administration) (Scotland) Regulations 2008, the Fund's annual report discloses performance against the measures detailed in the Pension Administration Strategy.

84. In relation to its own performance the Fund met all key performance targets with the exception of staff satisfaction with present job and investment performance.

85. The changes to the LGPS as a result of the Public Service Pensions Act will impact on administrative workloads going forward as will any further severance activity by employers. Auto enrolment will also affect information requirements and administration arrangements. There is a risk that the increased workload will increase pressure on staff and key tasks and statutory requirements will not be delivered.

Refer Action Plan no. 2

Employer Performance

86. Annual employer performance against the pension administration standards, as set out in the Pension Administration Strategy (PAS), has been consistently poor since their introduction three years ago. None of the five employer targets set out in the PAS were achieved in 2012/13. Exhibit 6 summarises the performance against target.

Exhibit 6: Employer performance against target

		2011/12		2012/13	
	Target (working days)	Number received	% within target	Number received	% within target
New member: paper forms	20	111	64	31	74
New member: electronic	20	1,779	90	2,693	89
Leaver information	20	1,049	69	592	64
Retirement information	20	917	39	803	39
Death in service information	10	39	30	37	19

Source: Audited Annual Report and Accounts 2012/13

87. The Employer On-line Portal for pension administration was implemented on a phased basis from November 2012. All employers currently have access to the system. The implementation of the system resulted in a significant improvement in performance in the final quarter of 2012/13.

Refer Action Plan no. 3

National performance reports

88. Audit Scotland carries out a national performance audit programme on behalf of the Accounts Commission and the Auditor General for Scotland. Reports in the last year which may be of interest to members and officers are detailed in Exhibit 7 below.

Exhibit 7: A selection of National Performance Reports 2012/13

- Managing performance: are you getting it right
- Responding to challenges and change - An overview of local government in Scotland 2013
- The National Fraud Initiative in Scotland
- How Councils work: using cost information to improve performance
- Managing early departures from the Scottish public Sector
- National Scrutiny Plan for Local Government

Source: www.audit-scotland.gov.uk

89. We suggest that officers review relevant national performance reports as they become available and consider any findings which may impact on the Pension Fund.

Outlook

90. Continuing to meet performance targets will become more challenging in the coming years. Investment targets are set based on advice from investment advisors and standard industry benchmarks. The Funds will have to remain vigilant, and ensure that they have the right diversification of Funds to deliver the required returns, whilst managing the investment risk.

91. Improvements that are being made to the pension administration system, and the way in which data is received, should improve performance going forward, although this is dependent on the provision of information timeously by scheduled and admitted bodies.

92. Increased workloads may affect staff morale and it is important that the Funds monitor workloads and plan accordingly.

Appendix A: audit reports

External audit reports and audit opinions issued for 2012/13

Title of report or opinion	Date of issue	Date presented to Committee
Annual Audit Plan	21 February 2013	13 March 2013
Report on financial statements to those charged with governance (ISA 260)	6 September 2013	20 September 2013 (Pension Audit Sub-Committee) 24 September 2013 (Pensions Committee)
Audit opinion on the 2012/13 financial statements	6 September 2013	20 September 2013
Report to Members on the 2012/13 audit	31 October 2013	16 December 2013 (Pension Audit Sub-Committee) 18 December 2013 (Pensions Committee)

Appendix B: action plan

Key Risk Areas and Planned Management Action

Action Point	1
Refer Para	37
Risk Identified	The changing profile of the Funds' membership may eventually result in monthly income not being sufficient to meet the Fund's monthly commitments, requiring the use of investment income to pay pension benefits. ***Risk: Financial plans prepared by the pension Funds are not achieved.***
Planned Management Action	Financial planning of the Funds continues to be reviewed regularly and appropriate cognisance is taken of actual and anticipated changes in membership profile. It should be emphasised that a reduction in contributions receivable in comparison to benefit expenditure, that is a move to a cash flow negative position requiring investment income to finance pension payments, is an inevitable consequence of a maturing Pension Fund. Management monitor short-term (monthly) cash flow to ensure there is sufficient cash to pay benefits and to ensure excess cash can be invested as soon as practical. Short term cash flow can fluctuate significantly. The Investment Strategy Panel considers medium-term (up to 2 year) cash flow projections on a quarterly basis. Long-term cash flow, including projection, is reported to Committee as part of funding and investment strategy reviews. The Fund has procured further long-term cash flow modelling from its actuary in order to provide requisite assurance in developing new contribution stability proposals, the results of which will be reported to the Pensions Committee in December 2013. The Fund will continue to monitor and manager cash flows.
Responsible Officer	Investment & Pensions Service Manager
Target Date	Ongoing

Action Point	2
Refer Para	85
Risk Identified	Changes to the LGPS as a result of the Public Pensions Act will impact on administrative workloads going forward as will any further severance activity by employers. Additionally auto enrolment will also affect information and administration arrangements. ***Risk: The increased workload will increase pressure on staff and key tasks and statutory requirements will not be delivered.***
Planned Management Action	It is recognised that impending reform of the LGPS in Scotland is likely to increase significantly the burden of pension administration. The risk is being managed. Lothian Pension Fund has included additional provision in its annual expenditure budget (from 2012/13) in anticipation of changes and has focused on enhancements both to operational efficiency and to data quality. Specifically, data quality improvements as a result of the system enhancements to transfer data electronically from employers to the Fund ("Employer On-line") should be most beneficial in the transition to a Career Average Revalued Earnings scheme. Communication to employers and other stakeholders of the LGPS reform issues by Lothian Pension Fund has been ongoing, with regular updates provided to both Pensions Committee and Consultative Panel. The most recent communication highlighted the proposed Heads of Agreement for the new scheme. The need to ensure that both employer HR / payroll systems and the pension administration software can cope with demands of a new scheme has already been raised at the Scottish Local Government Pensions Advisory Group (SLOGPAG) forum and also separately with CoSLA. Appropriate and timely liaison with the key system suppliers, at a national level, is therefore anticipated. There is certainly some degree of risk exposure for Lothian Pension Fund from the perspective of key staff expertise. During the year, steps have been taken to introduce greater flexibility in the organisational structure and also enhance career progression opportunity. Other measures have also been progressed with the intention of raising staff satisfaction levels. Hopefully, these should serve to alleviate such staff retention risk.
Responsible Officer	Investment & Pensions Service Manager
Target Date	Ongoing

Action Point	3
Refer Para	87
Risk Identified	Administration performance in relation to employers has been disappointing in 2012/13 with none of the five targets being achieved. ***Risk: delays in information provision may impact on the delivery of accurate and timely services to members.***
Planned Management Action	The Pensions Administration Strategy has been revised and approved by the Pensions Committee in September 2013, with an explicit objective to enhance employer data submission performance. Escalation procedures have been tightened and financial penalties for employer poor performance emphasised. On a positive note, as is stated, the investment in the "Employer On-line" portal has resulted in some improvement already to overall employer performance. This reflects the commitment of significant staff resources by the Fund to implement the project, supported by ongoing employer liaison. The intention is to capitalise on these initial gains and thereby secure excellence in service provision to customers. Progress is expected to be evolutionary, however, recognising the significant financial pressures facing public sector employers. Evidence from the England and Wales actuarial valuations 2013 has already pointed to reductions in overall pensions administration data quality arising from employer staffing cutbacks in HR and Payroll Sections.
Responsible Officer	Investment & Pensions Service Manager
Target Date	Ongoing

Pensions Audit Sub-Committee

10am, Monday, 16 December 2013

Internal Audit Bi-Annual Activity Report – December 2013

Item number	5.2
Report number	
Wards	All

Links

Coalition pledges	
Council outcomes	CO26
Single Outcome Agreement	

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Executive summary

Internal Audit Bi-Annual Activity Report – Dec 2013

Summary

Internal Audit has completed delivery of the 2012/13 audit plan within the period, and has commenced delivery of the 2013/14 audit plan. Within the period from June 2013 to Dec 2013, internal audit have completed two internal audits within the Pensions area of City of Edinburgh Council:

- Lothian Pension Fund – Control Testing
- Review of Controls around New Pension Payroll System – part 2.

Set out in appendix 1 are the key findings of these reports. A copy of all final reports is available to members.

Recommendations

The Committee is requested to note the progress of Internal Audit in respect of the 2012/13 internal audit plan and the areas of higher priority findings.

Measures of success

The Action Plans of these reports, when implemented, will demonstrate that the Council continues to strengthen its control framework and approach to risk management.

Financial impact

None.

Equalities impact

No full ERIA is required.

Sustainability impact

None.

Consultation and engagement

None.

Background reading / external references

None.

Coalition pledges	
Council outcomes	CO26 – The Council engages with stakeholders and works in partnerships to improve services and deliver agreed objectives.
Single Outcome Agreement	
Appendices	Appendix 1 - Internal Audit reports issued since 1 June 2013.

City of Edinburgh Council - Pensions

Internal Audit

Summary of Key Findings Report

(December 2013)

Note: All of the reports detailed in the report have been issued in final format and action plans have been agreed with relevant management.

All reports issued where there are any findings are the subject of a follow-up review which occurs between 4 and 8 months after the final report is issued. Any agreed actions which have not been implemented at follow-up review are reported to GRBV.

Contents

Section 1 – Lothian Pension Fund – Control Testing

Total number of findings

	Critical	High	Medium	Low	Advisory
Total	-	-	-	-	-

Background

As part of our audit plan a programme of Controls Testing across the Council is carried out throughout the year. Performance and progress in achieving the Council's objectives are monitored by Directors and Elected Members. Management is responsible for designing and implementing effective controls that achieve these objectives within the risk tolerance of the Council. Internal Audit provides an independent opinion on the effectiveness of these controls.

The Investment and Pensions Division of the City of Edinburgh Council is responsible for the specialist activities of investing and administering the following three pension funds:

- Lothian Pension Fund (Main Fund);
- Lothian Buses Pension Fund, and
- Scottish Homes (closed fund)

From the Lothian Pension Funds Annual Report 2011/12 – Unaudited for the year to March 2012 the following is noted:

- Lothian Pension Fund (The Main Fund) valuation increased from £3,477.5m to £3,584.2m;

- Lothian Buses Pension Fund increased from £257.0m to £271.4m, and
- Scottish Homes Fund increased from £124.3m to £131.4m.

As at 31st March 2012, Lothian Pension Fund membership was as follows:

- Main Fund - total membership of 66,354, including 28,337 active members;
- Lothian Buses Fund - total membership of 4,011, including 1,407 active members, and
- Scottish Homes Fund – total membership of 1,952. (This fund is now closed).

As part of our Council wide annual audit programme of controls testing a review was recently undertaken to ensure that key controls across the administration of the Pension Fund are in place and working effectively. The results of this review are provided to Audit Scotland to allow them to take assurance on the work undertaken by Internal Audit.

Remit and Scope of Internal Audit Work

The remit was to review the effectiveness of the controls in place to ensure that the following objectives are being met:

- there is a robust system in place to ensure that only correct and valid entries are processed to the funds administered by Investment and Pensions Division.

The scope was to:

- document the system and evaluate whether the procedures provide an adequate level of control;
- test the Investment & Pensions system Altair against the Council's pension payroll system within Trent, and
- interview key members of staff where applicable.

Summary of Findings

It is our opinion based on the work undertaken that reasonable assurance can be taken that the current controls are operating satisfactorily.

The following areas of good practice are noted:

- The Funds carry out an actuarial valuation every three years and the latest was at 31st March 2011;
- Altair v Trent system (Pension Payroll) reconciliations are carried out (on/around the processing cut off date of 8th of each month) with all anomalies investigated;
- Copies of the reconciliations are readily available;
- Flow charts are available within the Altair system which document all pension administration tasks and procedures. Updating of these and written procedures are an ongoing exercise.

Section 2 – Review of Controls around the New Payroll System – Part 2

Total number of findings

	Critical	High	Medium	Low	Advisory
Total	-	-	2	1	-

Background

Differences were identified between the Trent payroll and Altair admin system resulting in an unacceptable operational risk. It was decided that this risk was to be mitigated by the procurement of an integrated pension payroll and pension administration service.

The business case to migrate to an integrated pension payroll system was approved and the procurement of this service was completed during 2012 with Altair winning the tender.

The new Altair payroll system went live in September 2013 with data being input to payroll over the transition until the merger of systems is completed (estimated December 2013). This will then provide an integrated pensions admin and pensions payroll system. This integrated system should reduce the scope for previous issues from re-occurring.

Remit and Scope of Internal Audit Work

The remit was to review the new payroll system, specifically:

- Examine Heywood's Service Level Agreement to ensure there is appropriate Business Continuity coverage,
- Review system set up processes & controls and the validation of data,
- Assess reconciliation controls between payroll and pension systems*
- Evaluate controls around Altair's interface with the BACS system.

* This element of the remit was deferred until follow up audit, when the new system will be fully integrated and reconciliation controls can be appropriately assessed. A controls guidance note was separately issued to management instead.

Summary of Findings

From the review the following areas of good practice were identified:

- A standard application services provider agreement, covering the software use, support and maintenance services dated August 2009 exists between Heywood Limited and Lothian Pension Fund,
- At this stage, the project continues to be well managed with appropriate consideration and planning of processes and controls,
- There is a full suite of good controls currently used for the pre-merge payroll system, these are supported by procedure notes,
- There is a good audit trail of all amendments, alterations and additions for the new pre-merge payroll system; and
- A BACS transfer protocol transmits the secure BACS file to a secure holding area for the BACS bureau service provider to access and process. The BACS system is largely similar to the previous tried and tested procedure previously in place.

The following areas for improvement were identified:

- Under the Service Level Agreement with Heywood Limited, systems can be down for up to 48 hours within the business continuity procedures which may not be aligned to, or in accordance with, LPF's commitments,
- The Systems and Payroll Manager, who has full access to all payroll system functions and the ability to change access profiles, is not currently monitored to ensure there is no inappropriate transactions carried out, their integrity is not protected by the current segregation of duty controls; and

- The contracting out of LPF's BACS bureau service to BT has not been recently appraised in terms of vfm, emerging risks or provision through an in-house service.

It is our opinion based on the work undertaken that management are, at this stage, adequately considering processes and controls that should be in place to support an integrated pension payroll system. Management should however consider the areas for improvement identified by audit as well as take cognizance of the separately issued controls guidance note.

Pensions Audit Sub-Committee

10am, Monday, 16 December 2013

Investment Strategy Update

Item number	5.3
Report number	
Wards	All

Links

Coalition pledges	
Council outcomes	CO26
Single Outcome Agreement	

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Executive summary

Investment Strategy Update

Summary

The Pensions Committee agreed the Lothian Pension Fund's investment strategy in October 2012.

	Strategy 2012-17 %	Permitted Range %
Equities (1)	65	50-75
Inflation-linked assets (2)	7	0-20
Alternatives (3)	28	20-35
Cash	0	0-10
Total	100	

(1) Includes listed and private equity; (2) Includes index-linked gilts & bonds and gold; (3) Includes property, infrastructure, timber and corporate credit

The strategy targets lower risk and a move away from portfolios that are constrained by market capitalisation indices. This is reflected in a reduction in exposure to equities and an increase in exposure to index-linked bonds and alternatives.

Equities

An important element of the risk reduction comes from a shift within the equity allocation. The Fund appointed an external transition manager in November 2013 to reshape the equity allocation to reduce risk.

The Fund is moving decisively away from portfolios that are constructed along market capitalisation lines. A balance between capital preservation and growth are more important for the Fund than tracking error relative to a market capitalisation index.

The table below shows the change in the interim strategy benchmark between March 2013 and December 2013. It demonstrates how the transition will reduce the assets under management in regional equity portfolios and increase the assets under management in global equity portfolios. These global portfolios are characterised by significantly lower risk.

	Long Term Strategy 2012-17 %	Interim Strategy at 1 April 2013 %	Interim Strategy at 31 Dec 2013 %
Equities			
Regional Listed		44.5	19.7
Global Listed		19.5	44.3
Private Equity		6	6
Subtotal	**65**	**70**	**70**
Inflation-linked Assets			
Index Linked Gilts	7	5	5
Subtotal	**7**	**5**	**5**
Alternatives			
Property		10	10
Other Real Assets		8	8
Other Bonds		6	6
Subtotal	**28**	**24**	**24**
Cash		**1**	**1**
TOTAL	**100**	**100**	**100**

In addition, the transition increases the equity assets managed by the internal team. Approximately one third of the Fund's equities will be invested in the two internally managed global portfolios – one in high quality income-producing equities and the other in low volatility equities. Both portfolios will invest in companies with low volatility compared with the global equity benchmark and are expected to perform relatively well when equity markets are weak and produce positive absolute returns in rising equity markets. Over the long term, they are expected to enhance the Fund's risk-adjusted returns.

The transition is targeting a meaningful reduction in risk, and so, its scale is significant – purchases and sales of equities are approximately £1bn each, and involve a large number of securities.

An external transition manager from the Fund's panel has been appointed to carry out the transition. Members of the panel are selected because of the adequacy of their resources and their ability to minimise risks, which include maintaining the correct market exposure throughout the transition period and trading carefully to reduce market impact.

At the time of writing, equity assets are being transitioned. A verbal update will be provided to the Committee.

The internal team and the Investment Strategy Panel continue to research and review complementary equity strategies that can provide a suitable risk-adjusted return for the Fund.

Non-equity Assets

There have been no changes to the interim strategy allocations for inflation-linked assets and alternatives since 1 April 2013.

The Fund is continuing to identify and invest in attractive assets within the Alternative category, which includes assets with attractive yields and inflation protection, such as infrastructure, bond-like assets and timber. Recent investments have been made in UK Private Finance Initiative (PFI) projects, such as schools and hospitals, which offer stable income over the term of the concession periods and some protection against inflation.

Lothian Buses Pension Fund

The Fund's actual and benchmark allocation to each manager and asset class is shown in the table below together with the new investment strategy.

	Long Term Strategy 2012-17 %	**Interim Strategy wef 01/04/13 %**	**Actual Allocation 31/03/13 %**	**Estimated Allocation Post Transition 31/12/13 %**
Equities (Baillie Gifford)			59.9	31.1
Equities (internal)			5.0	31.1
Total Listed Equities			**64.9**	**62.2**
Private Equity (internal)			2.1	2.0
Total Equities	**55.0**	**62.5**	**67.0**	**64.2**
Index-linked Bonds (Baillie Gifford)	15.0	10.0	7.5	6.9
Index-linked Gilts (internal)				4.0
Total Index-linked Bonds	**15.0**	**10.0**	**7.5**	**10.9**
Other Real Assets (internal)		7.5	5.7	5.3
Other Bonds (Baillie Gifford)		10.0	7.7	7.3
Property (Standard Life)		10.0	7.9	9.0
Total Alternatives	**30.0**	**27.5**	**21.3**	**21.6**
Central Cash (internal)	0	0	4.2	3.3
Total Fund	**100.0**	**100.0**	**100.0**	**100.0**

The main focus of the implementation of investment strategy to date has been on equities given the Fund's significant exposure. After the shift away from UK equities to a global equity structure in March 2013, the focus has been on reducing the risk within the equities. The proportion of the Fund invested internally in high quality income-producing equities is expected to be increased in December to approximately 31%. At the same time the index-linked exposure will be increased by approximately 4% in an internal portfolio. These increases will be funded from the Baillie Gifford equity portfolio.

New investments have also been made in property and the exposure has increased by 1%. Opportunities to increase the Fund's investment in infrastructure continue to be explored.

The equity allocation will be reduced further over time as suitable alternative assets become available.

Scottish Homes Pension Fund

The Fund's strategic allocation is set out in the table below:

	Long Term Strategy 2012-2017 %	**Interim Strategy wef 01/04/13 %**	**Current Strategy wef 30/11/13 %**
Equities			
UK		8.8	6.6
US		12.4	9.3
Europe (ex UK)		8	6
Pacific inc Japan	**30**	7.6	5.7
Emerging markets		3.2	2.4
Sub-total		**40**	**30**
Bonds			
UK Fixed Interest Gilts		10	13
UK Index Linked Gilts	**65**	40	52
Subtotal		**50**	**65**
Property	**5**	**10**	**5**
Cash	**-**	**-**	**-**
TOTAL	**100**	**100**	**100**

Over the last year, the funding level of the Scottish Homes Pension Fund has increased gradually. As a result, the sale of equities and the move to the long term strategy has been accelerated.

In September 2013, the equity allocation was reduced to 35%. At the end of November 2013, the funding level increased further and was estimated to be in-line with the target funding level as prescribed in the agreement with Scottish Government (approximately 91%) and the equity allocation was reduced to 30%.

In addition, the property allocation of the Fund was reduced in the third quarter of 2013.

As at the start of December, the investment allocation of the Fund is in-line with the revised investment strategy for 2012-2017.

Further work to reduce the risk within the Fund's equities is the outstanding element of the implementation of the strategy. Further progress will be made once discussions with the Scottish Government on funding issues ahead of the 2014 actuarial valuation are complete.

Other Issues

Given the increase in assets under management by the internal team, the Fund has appointed an external, independent consultant to appraise the current risks for the Funds. The review will cover the following ten factors across operations, execution, and control functions:

- Governance
- Organisational structure and operating model
- Regulation ,compliance and audit
- Technology
- Risk Management
- Execution and controls
- Administration and controls
- Human capital
- Third party relationships and outsourced services
- Business continuity and disaster recovery plans.

The conclusions will be reported to Committee.

As part of the Fund's efforts to ensure industry best practice, it is also investigating whether there would be any benefits to the Fund becoming authorised by the Financial Conduct Authority (FCA).

Recommendations

The Committee is asked to note the progress made in implementing the Investment Strategy 2012-17, in particular the transition to lower risk equities.

Measures of success

The investment performance of the funds is crucial to the achievement of the required investment return which impacts on the funding level and employer contributions. The objectives for the investments are:

- Over long-term economic cycles (typically 5 years or more), the achievement o the same return as that generated by the strategic allocation;
- Over shorter periods, the Fund should perform better than the strategic allocation if markets fall significantly.

Financial impact

This report provides an update on investment strategy. The investment strategy has a significant impact on the funding levels and potentially on the contributions required from employers.

Equalities impact

There are no equalities implications as a result of this report.

Sustainability impact

The Statement of Investment Principles sets out the Funds' approach as responsible asset owners, and details how voting, engagement and other Environmental, Social and Governance activity is undertaken. Compliance with it is expected to contribute to the sustainability of the Funds' investments.

Consultation and engagement

The Consultative Panel for the Lothian Pension Funds, comprising employer and member representatives, is integral to the governance of the Funds.

Background reading / external references

None

Links

Coalition pledges	
Council outcomes	CO26 – The Council engages with stakeholders and works in partnerships to improve services and deliver agreed objectives.
Single Outcome Agreement	
Appendices	None

Pensions Audit Sub-Committee

10am, Monday, 16 December 2013

Global Custody Services Performance

Item number	5.4
Report number	
Wards	All

Links

Coalition pledges	
Council outcomes	CO26
Single Outcome Agreement	

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Executive summary

Global Custody Services Performance

Summary

This report presents the Key Performance Indicator Report for the 6 Months ended 30 September 2013 provided by Northern Trust. The purpose of this report is to demonstrate that the performance of the custodian is regularly monitored to ensure that the services provided meet the needs of the three Pension Funds.

The conclusion is that Northern Trust's services are meeting the needs of the three Pension Funds and are of a high standard.

Recommendations

Pensions Audit Sub-Committee is asked to note this report on the performance of the global custody service provided by Northern Trust.

Measures of success

Performance is measured against the indicators that have been set for the main services provided by Northern Trust.

Financial impact

The budget set for the provision of custody services for 2013/14 is £402k. This report has no impact on the cost of custody provision.

Poor performance of the custodian could have a financial impact on the three Pension Funds. For example: from delays in or failure to collect investment income or failure in the system to notify companies of decisions made in response to corporate actions. However, staff monitor service provision and corrective action would be taken if any issues were ever to arise.

Equalities impact

There are no equalities impacts arising from this report.

Sustainability impact

There are no sustainability impacts arising from this report.

Consultation and engagement

The Consultative Panel for the Lothian Pension Funds, comprising employer and member representatives, is integral to governance.

Background reading / external references

None

Report

Global Custody Services Performance

1. Background

1.1 Following a competitive tender process, Northern Trust has provided investment custody services since early in 2011 for the three Pension Funds. Provision of these services is vital to the management of the Funds' investments. The range of services includes:

- Proving investment valuations and accounts.
- Ensuring that investment transactions are processed within market requirements.
- Collecting investment income.
- Providing notification of all corporate actions and passing responses to the companies concerned.

1.2 In order to assess the services provided a number of key performance indicators have been agreed with Northern Trust. These indicators are subject of a report from Northern Trust, the latest of which is for the six months ended 30 September 2013. This is the first time that a report on custody services has been considered by Committee.

2. Main report

2.1 Page 2 of the appendix provides a summary of the status of the various performance indicators. In order to get a high level picture of performance the traffic light system is used. All of the performance indicators are on green with the exception of the one for corporate actions which is amber.

2.2 Information about all of the performance indicators is summarised below:

Month End Valuation Reporting

Description of Indicator	Month end valuation reports of investments completed and reviewed by Northern Trust and available to client within the target number of business days of end of the previous month.
Performance Traffic Lights	Green – Completed by business day 14 Amber – Completed by business day 15 Red – Completed by business day 16 or later
Service Rating	Green

Over Last Six Months to 30/9/13	Work completed by business day 14 for months April to September of 2013.
Comments	Unreviewed valuations are available on business day one; these are accurate for quoted investments. Portfolios that contain unquoted investments take longer for valuation information to be obtained. Month end valuations provided by Northern Trust are reconciled in terms investment holdings with records maintained by the external or internal investment manager. In addition, checks are made on the prices used by Northern Trust and the prices used by the external or internal investment manager.

Financial Reporting

Description of Indicator	Since April 2012 Northern Trust has been responsible for providing investment accounts for all three Pension Funds. This includes a month end trial balance and summary accounts and at the year end additional information for inclusion in the annual accounts. Month end investment accounting packs should be completed and sent to client within the target number of business days of end of the previous month.
Performance Traffic Lights	Green – Completed by business day 18 Amber – Completed by business day 19 Red – Completed by business day 20 or later
Service Rating Over Last Six Months to 30/9/13	Green Work completed by business day 18 for months April to September of 2013.
Comments	More time is allowed at the year end for the preparation of the additional information required for the annual accounts. The month end accounts are checked by the Fund for accuracy.

Trade Settlement Statistics

Description of Indicator	Each investment market around the world has a set of requirements that must be followed regarding the settlement of trades (purchases and sales). These requirements include a fixed number of business days for a trade to be settled. For example, shares trade in the UK must be settled in a three day period. Within that period each side must "deliver" either the shares or the funds as appropriate. The indicator is the percentage of trades that have settled on time.
Performance Traffic Lights	Green – 94% or higher Amber – 92% to 94% Red – 91% or lower
Service Rating Over Last Six Months to 30/9/13	Green 96.69%
Comments	During the period there were a total of 3,806 trades of which 3,680 (96.69%) were settled on time. Of the 126 trades settled late, 114 were purchases and 12 were sales. This reflects the main reason for late settlement that Lothian Pension fund experiences – that the selling broker does not initially have sufficient shares to settle the purchase trade. Northern Trust provides a range of reports on settlement statistics (see below) this includes one that provides information by broker. This is particularly useful for identifying the source of settlement problems. Northern Trust provides contractual settlement on all trades. So in the case of sale trades, Northern Trust will credit the Fund with the cash proceeds on the contractual settlement date of the underlying trade regardless of whether it settles on time in the market. Northern Trust would then seek compensation by issuing a market claim against the purchasing broker.

Income Collection Statistics

Description of Indicator	It is the responsibility of the custodian to account for all dividend income when it becomes due and to receive the money into the bank when the dividend is actually paid. The indicator is the percentage of the number of income payments received on pay day.
Performance Traffic Lights	Green – 95% to 100% Amber – 90% to 95% Red – 90% or lower
Service Rating Over Last Six Months to 30/9/13	Green 98.16%
Comments	The performance indicator is based on the number of income collections rather than their value. During the period there were a total of 1,846 income collections, 1,812 (98.16%) of which were received on the correct pay day. During the period the value of income collections was £56.9m, £56.0m (98.48%) of which was received on time – slightly higher than the statistic based on numbers. Northern Trust provides a range of reports on income receipts (see below) this includes one that provides information by country. This report would be useful to identify any problems at the market rather than individual company level. Northern Trust provides contractual income in 38 countries. This means that Northern Trust endeavours to credit the Fund's bank account with the income on its pay date irrespective of the actual date of receipt.

Corporate Actions

Description of Indicator	Corporate actions are events announced by companies that give shareholders the opportunity to make a decision on two or more potential choices. For example: • Rights issue to buy additional shares • Dividend reinvestment in additional shares • Receive dividend in GBP, USD or EUR It is the responsibility of the custodian to collate responses from its clients to corporate actions and communicate the results to the company. The Fund has the responsibility of responding to corporate actions on a timely basis. The indicator is the percentage of responses made by the client with the deadline date set by the company for a response. The Fund has the responsibility of responding to corporate actions on a timely basis.
Performance Traffic Lights	Green – 100% Amber – 95% to 99% Red – 94% or lower
Service Rating Over Last Six Months to 30/9/13	Amber 95.13% But see comments below about potential falsely recorded late responses.
Comments	During the period there were 308 corporate actions, 293 (95.13%) of which are recorded as having been responded to within the time limit. Northern Trust provide an online system to advise clients of all upcoming corporate actions for the investments that are held. The same system is used by the client to record decisions. As the deadline for an action approaches and no response has yet been recorded, Northern Trust staff will attempt to contact the client for a response. Contact is

	initially made by e-mail and on the day prior to the deadline contact by phone is attempted. In the event that a client response cannot be obtained Northern Trust will elect the default option for the action. Northern Trust have advised that there is an issue with the accuracy of their report in that there are potentially a number of false late responses for those actions where Northern Trust staff had chased for a response via the phone / e-mail and had been given a response that was not recorded on their system in time. In such a situation the company will have had the response in time but the statistics are not recording this. It is understand that Northern Trust hope to resolve this problem in time for the next report.

3. Recommendations

3.1 Pensions Audit Sub-Committee is asked to note this report on the performance of the global custody service provided by Northern Trust.

Alastair Maclean

Director of Corporate Governance

Links

Coalition pledges	
Council outcomes	CO26 – The Council engages with stakeholders and works in partnerships to improve services and deliver agreed objectives.
Single Outcome Agreement	
Appendices	None

Pensions Audit Sub-Committee

10am, Monday, 16 December 2013

Class Actions

Item number	5.5
Report number	
Wards	All

Links

Coalition pledges	
Council outcomes	CO26
Single Outcome Agreement	

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Executive summary

Class Actions

Summary

This report summarises activity on class actions.

A class action is when an investor agrees to act as a lead plaintiff in a case against a company. Typically, these actions happen in the US when a group of shareholders get together and sue a company to recover a loss in share value, or to exert influence on the company. A law firm fights the case on behalf of the class with the lead plaintiffs being treated as the representatives of the class. The cases can take several years to be heard by the courts and can be settled out of court. They are typically taken on a no win, no fee basis.

If a class action case is won, the compensation fund, net of legal fees approved by the court, is distributed to eligible shareholders who make a claim within the relevant time limit. Any shareholder that held shares during the class period is entitled to make a claim. The shareholders who lodge a claim share the compensation in proportion to the loss suffered. As shareholder, the Lothian Pension Fund claims for compensation on all relevant class action settlements.

In addition, the Lothian Pension Fund acts as lead plaintiff on a number of class actions, holding company management to account and aiming to deter future fraud and/or loss of shareholder value. This is consistent with its approach to environment, social and governance issues. Also, by acting as a lead plaintiff, the Fund may be in a position to influence the terms of the settlement. Summaries of the class actions where Lothian Pension Fund is acting as lead plaintiff are provided in the Appendix 1.

A court ruling in the case of Morrison vs. National Australia Bank (NAB) in 2010 has narrowed the ability of investors to seek redress under the laws of the US, particularly where shares are purchased on non – US stock exchanges.

Compensation received by the Fund from class actions is shown in the table below.

Financial Year	**US$ (000's)**
Prior to 31/03/10	1,614
2010/11	209
2011/12	317
2012/13	483
2013/14 **[1]**	207
TOTAL [1]	**2,830**

[1]To 31 October 2013

The last Committee report in December 2012 contained figures for the first half of the 2012/13 financial year. In the second half of that year a further $462k was received. This sum included large settlements from Countrywide and MF Global.

There have been 10 settlements so far this financial year, with a total value of $207k. Included in these figures is a large payout from a class action against National City Corp. The smaller payments included sums from class actions against Washington Mutual and Wellcare Health Plans.

The Morrison vs. NAB ruling continues to impacts on the Fund's ability to claim for compensation in the US. As a result of the ruling investors are increasingly looking to obtain compensation through other jurisdictions where the legal process may require investors to "opt-in" to the case prior to the trial if they wish to participate. Officers have reviewed a small number of such cases and Lothian Pension Fund will consider the potential benefits and risks on a case by case basis.

Recommendations

It is recommended that the Pensions Committee note the content of this report.

Measures of success

Success will be measured by the number of actions successfully pursued and the compensation received.

Financial impact

US class actions are conducted on a no win no fee basis. In the event of a case being won, the courts approve the legal costs which are deducted from the compensation fund. The Fund has recovered $2.8m in compensation from class actions.

Equalities impact

There are no adverse equalities impacts arising from this report.

Sustainability impact

Class action activity is undertaken as part of the Environmental Social and Governance (ESG) activity of the Fund which is expected to contribute to the sustainability of the Fund's investments.

Consultation and engagement

The Consultative Panel for the Lothian Pension Funds, comprising employer and member representatives, is integral to the governance of the Funds.

Regular updates on class actions have been provided to stakeholders.

Background reading / external references

Not applicable.

Links

Coalition pledges	
Council outcomes	CO26 – The Council engages with stakeholders and works in partnerships to improve services and deliver agreed objectives.
Single Outcome Agreement	
Appendices	Appendix 1 – Class Actions

APPENDIX 1 – CLASS ACTIONS

Summaries of the cases where Lothian Pension Fund is, or has been a lead plaintiff are outlined below:

- A case against Lehman Brothers is being progressed in relation to false financial statements and mismanagement at the company prior to the collapse of the bank. The case consists of separate claims against the directors, underwriters and auditors. The case was filed in 2008 and the estimated loss to the Fund is $4.7m. Shares were purchased in the US. In August 2011, the case against the company directors agreed a settlement of $90m. In May 2012 courts gave final approval to settlement of $90m with Lehman directors and officers and $426m with the underwriters. Litigation is ongoing with Lehman's accountants, Ernst & Young (E&Y). Although Lothian is lead plaintiff in the overall case it was not named as a class representative for the E&Y case. It was anticipated that settlement would be reached with Ernst &Young in the first half of 2013. However, although settlement is now nearing agreement, allocation of the settlement will be complex and is likely to be a lengthy process. As settlements are usually distributed together, this may delay receipt of settlement proceeds for all the different claims.
- The case against the pharmaceutical company Sanofi-Aventis was filed in 2007 and relates to misleading statements made by the company in relation to trials of a new drug, i.e. that the drug tests were successful when in fact the Company was receiving definitive information to the contrary. The Fund was initially serving as co-Lead Plaintiff alongside a pension fund from the United States and the Fund's loss was estimated to be $1.5m. However after the Morrison ruling Lothian Pension Fund was removed as Lead plaintiff because it had made a gain on the shares purchased in the US, the Fund's approx £1m loss was made on shares purchased in France. The US case settled for $40m but Lothian was not eligible to receive any of the US settlement fund. There is no known way to recover the non US loss and the French Statute of Limitation would likely preclude a claim. Lothian has now agreed to take no further action in this case.
- The Fund had an estimated loss of $2.0m due to holdings in the company Wyeth. The case is premised on Wyeth's (now Pfizer, as a result of a merger) misrepresentations of clinical trial results for the investigational Alzheimer's drug, bapineuzumab. The Fund was appointed co-lead plaintiff (along with Italian investment fund, Arca) in September 2010. In the summer of 2011, defendants moved to dismiss the case and were successful. An amended complaint was lodged but this was dismissed. An appeal brief was then lodged with the US Court of Appeals in Boston, and argument took place on September 9, 2013. A decision will not be issued for several months.
- The case against Genzyme was filed in 2009 and the Fund's losses are estimated to be $3.1m. The case relates to its failure to disclose serious issues at one of its manufacturing facilities that caused the company to halt production

of two of its top selling drugs due to contamination. The case was dismissed. However an appeal was lodged, as new information became available. The result of the appeal is pending.

Pensions Audit Sub-Committee

10am, Monday, 16 December 2013

EU Tax Claims

Item number	5.6
Report number	
Wards	All

Links

Coalition pledges	
Council outcomes	CO26
Single Outcome Agreement	

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Executive summary

EU Tax Claims

Summary

This report summarises activity on EU tax claims made on behalf of the Lothian Pension Fund.

Recommendations

Pensions Audit Sub-Committee is asked to note the progress made in reclaiming EU taxes suffered on dividends.

Measures of success

Success is measured by the amount of tax recovered exceeding the cost of pursuing the claims.

Financial impact

EU tax claims totalling in excess of £10m have now been lodged with the relevant tax authorities. Professional fees amounting to £493.3k have been incurred to date. As previously agreed by Pensions Committee, it is likely that further legal costs will be incurred in pursuing the claims. However, any legal costs are shared across a pool of fellow claimants and Lothian Pension Fund has the right to cease participation without incurring further costs.

Currently, claims paid to date exceed the costs incurred by £561.6k. The financial position can be summarised as follows:

	Total Claims £'000	**Claims Settled £'000**	**Claims Outstanding £'000**	**Costs to Date £'000**
Claim Type				
Manninen	2,626.7	Nil	2,626.7	49.5
Fokus Bank	3,535.7	1,054.9	2,480.8	351.8
Manufactured Dividends	3,928.6	Nil	3,928.6	92.0
	10,091.0	**1,054.9**	**9,036.1**	**493.3**

Equalities impact

There are no equalities impacts arising from this report.

Sustainability impact

There are no sustainability impacts arising from this report.

Consultation and engagement

The Consultative Panel for the Lothian Pension Funds, comprising employer and member representatives, is integral to governance

Background reading / external references

None

Report

EU Tax Claims

1. Background

1.1 EU tax claims relate to the recovery of tax deducted from dividend payments prior to receipt. They relate to a fundamental principle of EU law, that all member states should not discriminate in the application of national taxes between home tax payers and those in other member states.

1.2 The claims can be divided into three main types – Manninen, Fokus and Manufactured Dividends.

2. Main report

Claims for EU Tax Credits – Manninen

2.1 This claim is against the UK tax authorities and is based on HMRC permitting the repayment of tax credits deducted from UK dividends but not on Foreign Income Dividends paid by UK companies.

2.2 The European Court of Justice's ruling in the Manninen tax case in September 2004 opened an avenue for claims for tax credits on EU dividends. Pensions and Trusts Committee has previously agreed to pursue potential claims.

2.3 Based on the decision in the Manninen case, KPMG's EU Tax Group is undertaking claims on behalf of UK pension funds to claim a repayment of tax credits on dividend income for the period 6 April 1992 to 1 July 1997.

2.4 The claims are based on 20% of the gross dividends received. While the UK tax authorities are disputing the validity of such claims, the estimates show that the Lothian Pension Funds could benefit by up to £2.6m from a successful claim. A cost benefit analysis concluded that a claim should be lodged, and this was done on 9 February 2006.

2.5 HMRC has rejected all claims of this nature. As a result, KPMG has appointed a firm of solicitors (Pinsent Masons) to pursue recovery.

2.6 A brief chronology of events to date is provided in the table below:

Date	**Event**
March 2011	First-tier Tribunal (FTT) published its judgement on the test case: • Withholding of tax credits on foreign income dividends was a breach of EU law. • Claims were out of time because they were made more than six years after the end of the tax year in which the relevant dividends were received. The FTT rejected legal arguments that the statutory time limits should be extended.
July 2012	Appeal against the FTT judgement was heard by the Upper Tribunal.
February 2013	Upper Tribunal published its judgement on the appeal and supports judgement of the FTT.
May 2013	Upper Tribunal refuses HMRC's request for leave to appeal on the substantive issue and claimants' request on the out of time issue.
July 2013	Court of Appeal approves direct requests to appeal from HMRC and claimants.
September 2013	Court of Appeal advises that a preliminary hearing will be held in December 2013 to decide if any questions related to the case should be referred to the Court of Justice of the European Union.

2.7 Based on the above, it could be well into 2015 before a final decision is reached.

2.8 Fees incurred to date, by Lothian Pension Fund, on these claims amount to £49.5k. Assuming that the case is pursued to a final conclusion, total costs for the Fund are capped at £90k. This compares with the claim for £2.6m.

Claims for EU Tax Credits – Fokus Bank

2.9 These claims are against the tax authorities of the EU member states (and Norway) in which we have invested. The basis of the claims is that the tax authorities have applied favourable tax treatment to domestic pension funds that they have denied to pension funds in other member states.

2.10 The Pensions and Trusts Committee of October 2007 approved making claims under the principle established in the Fokus Bank case. Claims currently estimated at around £3.5m have been made. Progress on the claims is summarised in the table below.

Country	**Claim Period From / To**	**Estimated Amount Claimed £'000**	**Amount Received £'000**	**Notes**
Completed Claims				
Austria	2006 2010	83.0	83.0	Claim paid in September 2012.
Netherlands	2003 2006	440.0	440.0	Claim paid in 2009.
Norway	2004 2010	273.0	273.0	All claims paid - final instalment received in February 2013 (£73k)
Active Claims				
France	2005 2009	658.0	-	15% tax imposed on all pension funds from 1 January 2009 – so no further claims can be made after that date. In May 2012, the EU Court ruled in the Santander test case that refunds must be paid to investment funds. Since the last report to Pensions Committee in March 2013, the total claim has been reduced from €1,225m to €776k as result of claims for 2003 and 2004 being considered to be out of time as a result of case law. Work currently being done to comply with the detailed documentary requirements of the French authorities.
Germany	2003 2010	911.6	-	While the principles behind the claims seem to have been accepted by the German tax authorities, they are currently refusing to clarify the procedure that has to be followed to obtain payment of the claims. KPMG is still considering whether it would be appropriate to file a test to accelerate payment.

Country	Claim Period From / To	Estimated Amount Claimed £'000	Amount Received £'000	Notes
Italy	2004 2010	508.7	-	There is the possibility that a test case may start in approximately six months. It is reported that the Italian tax authorities have a poor record of responding to tax repayment claims.
Spain	2004 2009	661.4	258.9	In May 2013 the Courts decided that the claims for 3 quarters of 2004 should be refunded. Lothian received a refund of €93,704 (£78.9k) including interest. In early November 2013, we were advised that claims from final quarter of 2004 to the first quarter of 2006 have been paid to our Spanish agent. This amounts to €215,709 (£180.0k). This gives us some confidence that the remaining claims will be paid in due course.
TOTAL		**3,535.7**	**1,054.9**	

2.11 Exchange rate movements change the potential value of the claims in sterling terms.

2.12 Fees incurred to date on these claims amount to £351.7k. Costs are higher for the Fokus Bank type claims because of the need to file claims separately in individual EU countries.

Claims for EU Tax Credits – Manufactured Dividends

2.13 This claim is against the UK tax authorities. It is based on the fact that manufactured dividend receipts relating to UK shares are not subject to any UK withholding tax but receipts relating to overseas dividends suffer a UK withholding tax of 15%.

2.14 Note that manufactured dividends are dividends created when a security is out on loan at the time the company pays a dividend.

2.15 Claims in respect of manufactured dividends totalling £3.9m has been lodged with HMRC.

2.16 KPMG has appointed a firm of solicitors (Pinsent Masons) to pursue recovery. Pinsent Masons have been working with HMRC to agree a test case process, the aim being to have the case heard by the First-tier Tribunal (FTT).

2.17 An initial hearing of the FTT took place in March 2013. HMRC are required to prepare a statement of their case by the end of November 2013. It is hoped that the FTT will hear the case during 2014.

2.18 Reference to the European Court of Justice would take a further two years. With potential subsequent referrals (maximum of three), a final decision may not be made until 2016/2017.

2.19 Fees incurred to date on these claims amount to £92.0k. Potential subsequent referrals are estimated to cost £20k for each stage.

3. Recommendations

3.1 Pensions Audit Sub-Committee is asked to note the progress made in reclaiming EU taxes suffered on dividends.

Alastair Maclean

Director of Corporate Governance

Links

Coalition pledges	
Council outcomes	CO26 – The Council engages with stakeholders and works in partnerships to improve services and deliver agreed objectives.
Single Outcome Agreement	
Appendices	None

Pensions Audit Sub-Committee

10am, Monday, 16 December 2013

Risk Management

Item number	5.7
Report number	
Wards	All

Links

Coalition pledges	
Council outcomes	CO26
Single Outcome Agreement	

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Director of Corporate Governance

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EDINBVRGH
THE CITY OF EDINBURGH COUNCIL

Executive summary

Risk Management

Summary

Our risk management procedures require us to:

(i) maintain a detailed operational risk register which sets out all the risks identified and assessed by the officers on an ongoing basis, the degree of risk associated in each case and our action to mitigate these risks (the "**Operational Risk Register**"); and

(ii) produce a summary report of the risk register for the Pensions Committee and the Pensions Audit Sub-Committee which highlights the material risks facing the pension funds and identifies any new risks/concerns and the progress being made over time by the officers in mitigating the relevant risks (the "**Quarterly Risk Overview**").

The Operational Risk Register has been issued to the conveners of the Pensions Committee and the Pensions Audit-Sub-Committee.

The Quarterly Risk Overview as at 15 November 2013 is set out in the appendix to this report.

Recommendations

We recommend the Committee notes the Quarterly Risk Overview.

Measures of success

Improved visibility of the risks facing the pension funds and progress in analysing/mitigating these risks. Regular, focused and relevant risk updates to the Pensions Committee and Pensions Audit Sub-Committee should increase general awareness and allow productive analysis/feedback by the Pensions Committee/Audit Sub-Committee members on these fundamental issues.

Ultimately, risk management should lead to less third party exposure, an improved financial position and have a positive impact on the reputation of the pension funds.

Financial impact

There are no direct financial implications as a result of this report.

Equalities impact

None.

Sustainability impact

None.

Consultation and engagement

The Consultative Panel for the Lothian Pension Funds, comprising employer and member representatives, is integral to the governance of the Funds.

Background reading / external references

None.

Links

Coalition pledges	
Council outcomes	CO26 – The Council engages with stakeholders and works in partnerships to improve services and deliver agreed objectives.
Single Outcome Agreement	
Appendices	Appendix 1 - Committee Risk Summary as at 15 November 2013

Lothian
PENSION FUND

QUARTERLY RISK OVERVIEW

15 November 2013

UPDATE ON MOST NOTABLE RISKS

Risk	Update
Investment performance leading to pressure on employer contribution	The new lower volitility investment strategy continues to be implemented.
Adverse movement against non-investment funding assumptions leading to pressure on employer contributions	Meetings have been held with the Funds' Actuary to schedule analysis on employer contributions and funding assumptions ahead of the 2014 actuarial valuation and a contribution stability mechanism has now been proposed to Committee. We are in the process of liaising with employer bodies on this mechanism.
Collapse/restructuring of an employer body leading to pressure on other employers	Engagement with employers and guarantors is underway as part of the preparation for the 2014 actuarial valuation. This will result in work-streams to implement payment plans and other arrangements to mitigate the impact on other employers in the Fund. We await final responses to the employer survey and will shortly be analysing this data to asses employer covenant and feed into the process of our engagement with employers on both contribution stability and legal terms for admission/guarantees.
Recruitment and retention of key staff	The likelihood of this risk occurring has been slightly increased to reflect the passage of time which has elapsed since this risk was first identified and the possibility of an improving economic climate in the UK in 2014 which may lead to a more buoyant HR market in the fund management sector. A consultant has now been appointed to carry out a review of our internal investment function and a verbal update will be provided to Committee.
Risk of incorrect pension payments	The project to integrate the pensions payroll into the pensions administration IT system is on target to complete by the end of 2013. Full reconcilliation of payments has reduced the risk. The new controls and processes have been subject to an internal audit and the results were reported to the Audit Sub-Committee.

Business continuity issues (accommodation, staff etc.)

This risk continues to remain higher than we would normally expect due to the pending office move in January 2014. Detailed contingency planning/project management is being implemented (in relation to the 'Fit-Out', IT and Systems, legal terms, contractual/operational/other notifications and communications etc.) to ensure that the risk of any disruption to service provision is minimised.

Portfolio Transition Issues

This risk continues to remain higher than we would normally expect due to the pending in-house Portfolio Transition due to take place in the last quarter of 2013. An external transision manager has now been appointed to assist us with this and mitigate any potential risk given the scale of the transition. We anticipate that this transition will have completed by the time of the Pensions Committee meeting in December 2013.

Regulatory Breach

The likelihood of regulatory breach has been slightly increased to reflect the fact that we are currently in the process of addressing our obligations under the recent EMIR legislation, brought in to regulate the use of 'over the counter' derivatives and mitigate against possible counterparty credit risk (one of the contributory factors to the 2008 global financial crisis). We are in the process of addressing our obligations and updating our contractual agreements with managers/custodian to ensure that we (through our agents) act in compliance with these new laws. We would anticipate this risk will be reduced once the process has been concluded by January/February 2014.

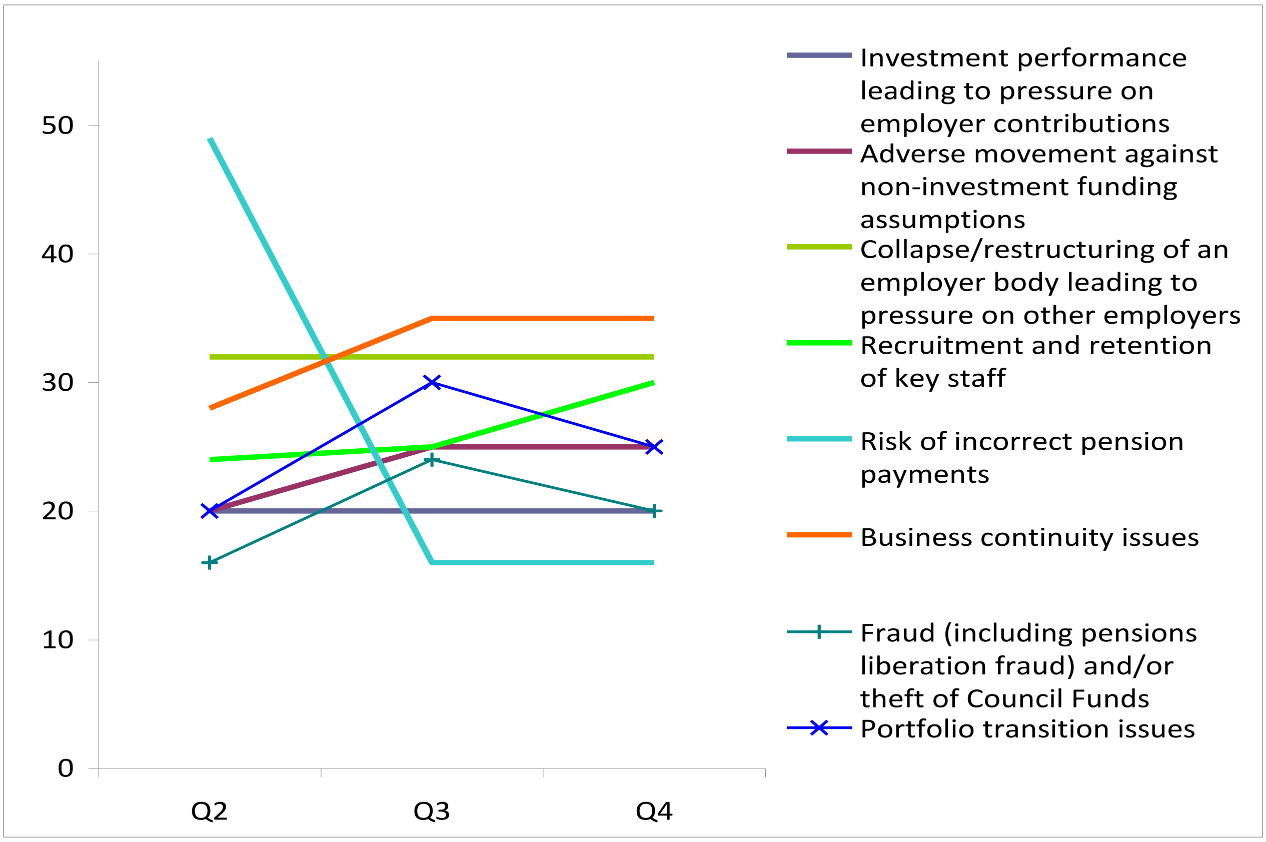
Fraud (including pensions liberation fraud) and/or theft of pension fund monies

We have decreased the risk around Fraud to reflect the reduced number of new pensions liberation cases we are seeing, the impact of our specific processes/procedures to address this and the progress being made by the FCA, HMRC and The Pensions Regulator in raising awareness and combating this form of fraud. We note the need for continued vigilance in this area.

Breach of contract

We are currently in the process of liaising with the Council's Information Compliance team and reviewing our contracts in the context of the Council's current approach to disclosing Freedom of Information requests and responses.

NOTABLE RISKS: PROGRESSION OF CURRENT RISK (ACCOUNTING FOR CONTROLS) IN LAST THREE QUARTERS



OTHER KEY POINTS

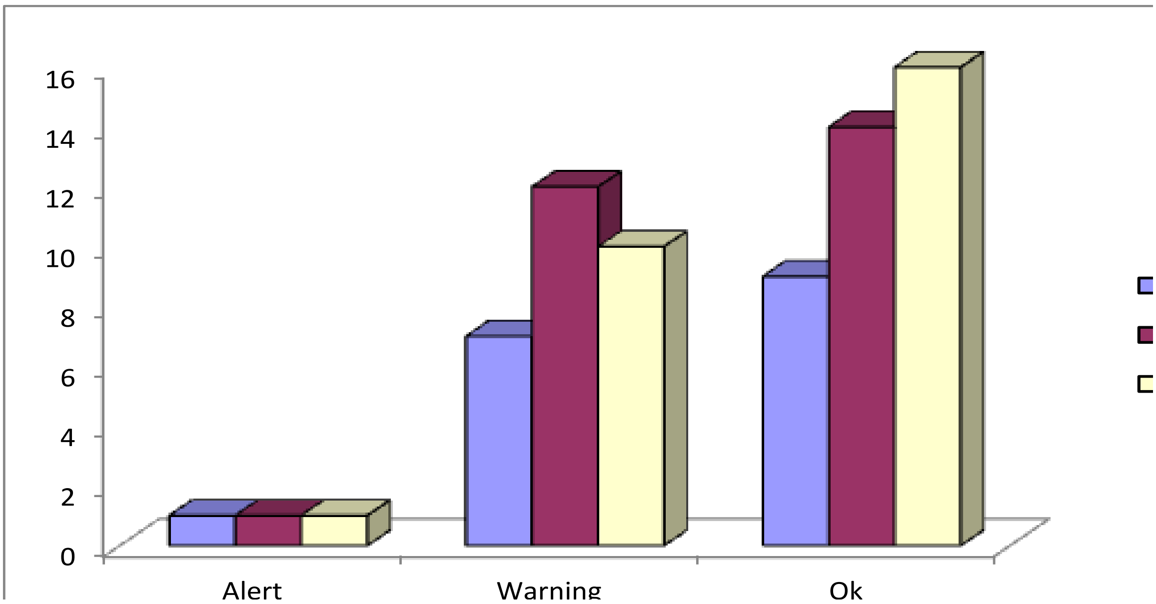
	Comments
New significant risks	None
Other new risks	A new risk of "Late Payment of Pensions" (as distinct from incorrect pension payments) has been included to more properly distinguish the change in risks associated with the payment of pensions to members following the transfer of pension payroll to the pensions administration system.
New controls	Controls have been introduced to avoid any late payment of pensions, including (i) Staff responsibilities for the pensioner payroll function have been designed to ensure there is appropriate coverage at all times, and (ii) contingency measures are in place which will ensure payment is made should Altair or BACS fail.
Eliminated risks	None
Notable initiatives / actions	Risk analysis of the internal investment function by consultants. Contingency planning for the office move. Employer survey/engagement and contribution stability mechanism as part of the preparations for the 2014 actuarial

valuation.

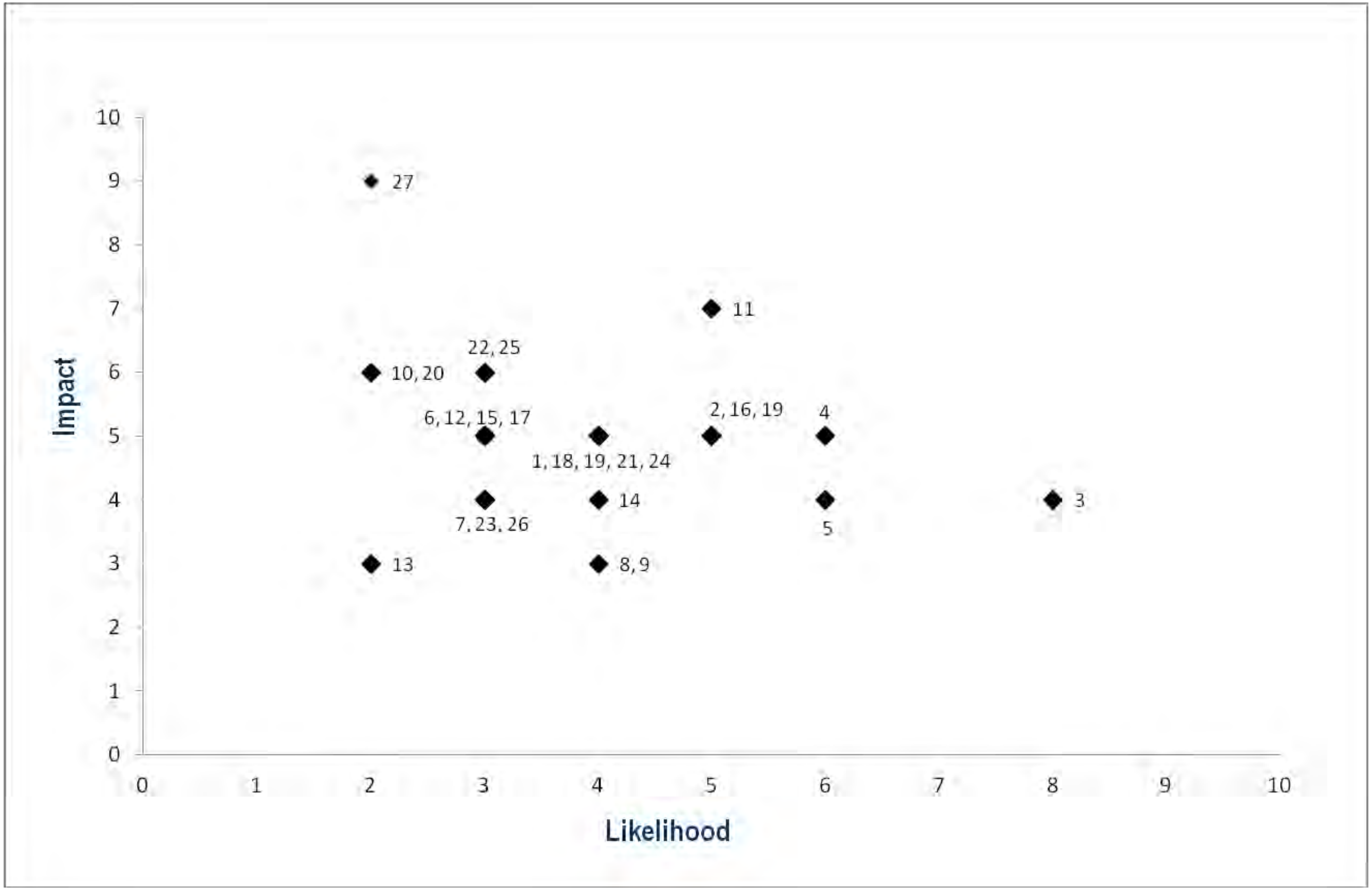
Engaging in the City of Edinburgh Council's assurance mapping project, effectively being a risk audit of our entire business function/division. Initial feedback from our responses has been positive.

Material Litigation None

All Risks: Status Overview



All Risks: Impact and Likelihood Overview



Key: Risks by Number

1	Investment Performance pressure on employer contributions	15	Market abuse by investment team
2	Adverse Movement - pressure on employer contributions	16	Portfolio transition issues
3	Collapse of an employer	17	Disclosure of confidential information
4	Retention of key staff	18	Material breach of contract
5	Fraud or theft of Council/Pension Fund assets	19	Regulatory breach
6	Staff negligence	20	FOI process in accordance with law
7	Failure of IT systems	21	Incorrect communication with members
8	Employers HR decisions without consideration of fund	22	Acting in accordance with proper authority/delegations
9	Elected members take decisions against sound advice	23	Inappropriate use of pension fund monies
10	Failure to complete annual accounts	24	Procurement/framework breach
11	Business continuity issues	25	Non-compliance with the new LGPS
12	Members' confidential data is breached	26	Claim or liability arising from shared services
13	Loss due to stock lending default	27	Late Payment of Pensions
14	Risk of incorrect pension payments		

Pensions Audit Sub-Committee

10am, Monday, 16 December 2013

Agenda Planning

Item number	6.1
Report number	
Wards	All

Links

Coalition pledges	
Council outcomes	CO26
Single Outcome Agreement	

Alastair Maclean

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Executive summary

Agenda Planning

Summary

This document is to give Committee an initial indication of the agenda for the next Pensions Committee and Audit Sub Committee meetings in March 2014 and throughout the rest of 2014. It also provides a more general overview of the current cycle of papers for Committee (see appendix).

Based on this cycle, the papers for the 2014 meetings are set out below.

There will, of-course, be specific matters and papers which need to be brought to the attention of the Pension Committee and the Audit Sub-Committee in addition to those set out herein.

Pensions Committee Agenda - March 2014

The following papers are currently scheduled for the March Pensions Committee meeting:

- 2013 Service Plan update
- 2014 Service Plan and Budget
- Investment Controls and Compliance
- Update on Employer Admissions in LPF
- Risk management summary

Pensions Audit Sub Committee Agenda - March 2014

It is proposed that the Pensions Audit Sub-Committee does not meet in March 2014. This is subject to discussion on the preparation of audit plans under item 5.1 of the agenda.

June 2014 agenda

Pensions Committee Agenda

- LPF Annual Report (& Accounts) Unaudited
- Statement of Investment Principles
- Investment Strategy Panel activity
- Annual Investment Update
- Training Activity (Committee and Panel)
- Service Plan Update
- Risk management summary

Pensions Audit Sub Committee

- LPF Annual Report (& Accounts) Unaudited
- Risk management summary

September 2014 agenda

Pensions Committee Agenda

- Discretions
- LPF Annual Report (& Accounts) Audited
- ISA 260 Audit Report
- Update on Employer Admissions in LPF
- Annual Performance Report and Benchmarking
- Service Plan Update
- Training Activity
- Risk management summary

Pensions Audit Sub Committee

- LPF Annual Report (& Accounts) Audited
- ISA 260 Audit Report
- Investment Income Review- Cross Border Withholding Tax
- Annual Performance Report
- Pensions Data Quality
- Fraud Prevention
- Risk management summary
- Delegated authorities - Write offs

December 2014 agenda

Pensions Committee Agenda

- Consultative Panel Membership
- Annual Report by External Auditor
- Actuarial Valuations (if complete)
- Funding Strategy Statement (if complete)
- EU Tax Claims
- Class actions
- Environmental Social and Governance Activity Update
- Service Plan Update
- Risk management summary

Pensions Audit Sub Committee

- Annual Report by External Auditor
- EU Tax Claims
- Class actions
- Service Plan Update
- Investment Controls (custody, currency, taxation, S Lending) TBA
- Risk management summary

Additional Papers

The following papers are examples of the types of papers that may be added to the agenda:

- Referrals and recommendations from the Pensions Audit Sub Committee
- Reports on completed audits
- Delegated authorities – Appointment of Providers
- Investment Strategy Reviews
- Regulatory update, particularly on scheme reform
- Funding Level Update
- Papers to address and update the Pensions Committee on specific initiatives being carried within LPF

Frequency	Pensions Committee	Audit Sub Committee	Month
Annually	N/A	Audit plans and reports (internal and external)	March (TBC)
	Service Plan and Budget	N/A	March
	LPF Annual Report (& Accounts) **Unaudited**	LPF Annual Report (& Accounts) **Unaudited**	June
	Statement of Investment Principles	N/A	June
	Investment Strategy Panel Activity	N/A	June
	Annual Investment monitoring – LPF/LBPF/SHPF	N/A	June
	Training Activity	N/A	June
	No	Audit Plan	
	LPF Annual Report & Accounts **Audited**	LPF Annual Report & Accounts **Audited**	September
	ISA 260 Audit Report	ISA 260 Audit Report	September
	N/A	Pensions Data Quality	September
	N/A	Investment Income Review-Cross-Border withholding tax	September
	N/A	Delegated authorities: Write offs -	September
	N/A	Fraud Prevention	September
	Annual Performance Benchmarking	N/A	September
	Consultative Panel Membership	N/A	December
	Annual Report by External Auditor	Annual Report by External Auditor	December
	EU Tax Claims & Income Recovery	EU Tax Claims & Income Recovery	December
	Class Actions	Class Actions	December
	Environmental Social and Governance Activity	N/A	December
	No	Investment Controls & Compliance	December

Frequency	Pensions Committee	Audit Sub Committee	Month
Semi Annually	Update on Employer Admissions in LPF	N/A	March & September
Quarterly	Risk management summary	Risk management summary	
		N/A	
	Service Plan Update	N/A	
Every 2 years	Policies/Strategies e.g. Training, Communications	N/A	March
Every 3 years	Actuarial Valuation: LPF/LBPF/SHPF	N/A	Dec/March
	Funding Strategy Statement	N/A	Dec/March
As required	Delegated authorities (provider appointments)	N/A	
	N/A	Audit reports	
	Referrals / recommendations from Pensions Audit-Sub Committee	N/A	
	N/A	Internal Audit Reports	
	Regulatory Update	N/A	
	Funding Level Update		
	Investment Strategy Reviews (at least every 3 years)	N/A	