

Pensions Audit Sub Committee

2.30 p.m., Monday, 22 September 2014

Review of Investment Operations

Item number	5.3
Report number	
Executive/routine	
Wards	All

Executive summary

This report summarises the key matters in relation to the investment controls and development of the in-house investment operations. These are:

- **Investment controls and consultant's recommendations:** the Fund has made significant progress in reviewing and implementing the recommendations of the external consultant following their review of the in-house investment operations in December 2013.
- **Financial Conduct Authority (FCA) Authorisation:** the Fund is making progress in seeking authorisation from the Financial Conduct Authority (FCA) in order to strengthen internal controls and facilitate further development of the in-house investment function.

Links

Coalition pledges

Council outcomes

CO26 –The Council engages with stakeholders and works in partnership to improve services and deliver on agreed objectives.

Single Outcome Agreement

Report

Review of Investment Operations

Investment Controls

Following the review of the Fund's in-house function by external consultants, the recommendations have been considered and action prioritised in order to improve controls. Importantly, the Fund has sought to apply a cost/benefit analysis to determine whether, and when, it would be most appropriate to implement particular recommendations (e.g. some being more appropriate to circumstances which may arise in the future, but would not be justified in the context of the current activities of the in-house investment team).

As reported to Committee in March 2014, the review concluded that the Fund's existing systems and controls are generally sufficient for the Fund's current investment activity.

The recommended improvements have been considered by the Fund and progress made in a number of areas. The key recommendations of the report are outlined below with an update provided on each:

- **Dedicated front office systems:** a dedicated front office portfolio management system (in relation to reviewing, managing and confirming portfolio/stock details, trades etc.) would be required in the event of increased investment activity.

Update: There has been no increased level of activity and hence this has not been pursued further at this stage. The need for such a system will be kept under review.

- **Operational due diligence on custodian and external investment managers:** the Fund currently carries out regular reviews of underlying investments and periodic reviews of the custodian and external managers. The consultant recommended more detailed and regular operational review of providers' systems and alignment with the Fund's requirements.

Update: Some, albeit limited discussions have been held with providers so far. With the completion of the Fund's accounts for 2013/14 and the appointment of a replacement Finance Manager for the Fund, this action will be progressed.

- **Staff remuneration and retention:** the review identified that the Fund does not externally benchmark salaries and that the notice period provisions in staff contracts were not in line with market practice for the relevant roles. The consultant also noted that the Fund adheres to wider Council Human Resource (HR) policies and procedures but ideally special arrangements should be made for key staff to mitigate this risk.

Update: Options to manage this risk have been considered in some detail and recommendations are provided separately on the agenda.

There has also been progress on a number of other improvements, including:

- An audit of the currency trading of the Fund which will be reported to Pensions Audit Sub-Committee on 22 September 2014;
- Changing the sign-off for alternative investments to formally recognise that decisions are made by the relevant internal investment committee, rather than solely the Investment & Pensions Service Manager;
- Various procedural changes relating to instructions and authorisations between the investment managers and administrators.

An update on all the recommendations has been provided to the Convener of the Pensions Committee, the Convener of the Pensions Audit Sub-Committee, the Independent Professional Observer and the Investment Strategy Panel.

FCA Authorisation

The critical matter to determine for the application for FCA authorisation is the extent of regulatory permissions that the Fund is looking to obtain. This determines what the Fund can do in the regulated environment, the complexity of the level of regulation that will apply to it and also the resource/cost burden of maintaining this entity. We are in the process of refining the Business Plan, which is required for the application.

Initially, the Fund will be looking to limit the scope of permissions to those relating to advising on and dealing in investments (e.g. we will not be seeking permissions that relate to the custody of assets or operating collective vehicles etc.) and so we will be subject to a lower level of regulation. Consequentially the capital requirements and resource/cost burden of managing and administering the vehicle will be kept to a relative minimum. It is worth noting that there is scope to vary the FCA permissions at a later date if required in the future.

Work is underway to establish what would be required, internally, to set up the vehicle which would apply for the FCA authorisation and to consider the accounting, tax and employment implications. It is likely that the vehicle would be a UK limited company, to ensure that the Fund/Council's exposure to liability in relation to the activities of the entity are limited to the extent of its regulatory capital. These discussions are ongoing. Critically, the vehicle will be wholly owned by the City of Edinburgh Council in its capacity as administering authority of the pensions funds, so all costs and returns will flow to and from the pension funds (with statutorily ring-fenced finances). Assurance from external legal and financial advisors on particular aspects of the structure (including on the tax and employment implications) is likely to be sought.

Separately, work is underway to determine the current regulatory position of the in-house investment team, as this will feed into the Business Plan.

Further work will involve producing a Compliance Manual suitable for an FCA authorised entity and in ensuring staff that will FCA authorised undertake the necessary training and, if appropriate, qualifications. The majority of the investment team have previously held approved person status and so it is not anticipated that this process would be overly onerous.

It is expected that the application to the FCA will be submitted within the next six months and the FCA will then have between 6-12 months to consider this and come to a decision. Initial indications from the FCA are that the previous backlog of applications is now being cleared. Therefore they may not require the full 12 months for the Fund's application which is likely to be a relatively straightforward application by comparison with others.

Recommendations

- 1.1 It is recommend that Committee notes the progress made in relation to implementing the recommendations of the external consultant and in seeking FCA authorisation and highlights any points it would like to raise at the Pensions Committee on 23 September 2014.

Measures of success

- 2.1 That the Fund continues to develop efficiencies for the benefit of its members, employer bodies and the taxpayer, while mitigating any risk associated with the necessary arrangements, and seeks to continue to improve its service provision and adapt the operations to the wider structural changes facing public sector pension funds.

Financial impact

- 3.1 There is no direct financial impact associated with the update of progress in relation to the matters set out in this report. Costs associated with implementing investment operation improvements and seeking and maintaining FCA authorisation are contained within the agreed budget for 2014-17. Improved operations should reduce financial risks.

Risk, policy, compliance and governance impact

- 4.1 The review of operations highlighted areas for the improvement of governance and risk and these are being implemented.

Equalities impact

- 5.1 None.

Sustainability impact

- 6.1 None.

Consultation and engagement

- 7.1 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.

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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