Notice of meeting and agenda

Pensions Audit Sub Committee

2.30pm, Tuesday 16 December 2014

Diamond Jubilee 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 Previous Minute 22 September 2014 – Submitted for approval as a correct record (circulated)

5. Reports

5.1 Agenda Planning – report by the Director of Corporate Governance

5.2 Report by the External Auditor on the Annual Report 2014 of Lothian Pension Fund, Lothian Buses Pension Fund and Scottish Homes Pension Fund – report by the Director of Corporate Governance

5.3 Lothian Pension Fund – Internal Audit Update 2014/15 – report by the Director of Corporate Governance

5.4 EU Tax Claims - report by the Director of Corporate Governance

5.5 Global Custody Services Performance - report by the Director of Corporate Governance

5.6 Investment Income Review - Cross Border Withholding Tax - report by the Director of Corporate Governance

5.7 Class Actions - report by the Director of Corporate Governance

5.8 Risk Management - report by the Director of Corporate Governance

6. Motions

6.1 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.

Minutes

Pensions Audit Sub-Committee of the Pensions Committee

2.30 pm, Monday 22 September 2014

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 16 June 2014 as a correct record.

2. Agenda Planning

An overview of potential reports for future Pensions Committee and Pensions Audit Sub-Committee meetings for December 2014 and March 2015 was outlined.

Decision

To note the agenda planning document.

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

3. Audited Annual Report 2014 of the Lothian Pension Fund, Lothian Buses Pension Fund and Scottish Homes Pension Fund

Details were provided of the Annual Report for the Lothian Pension Fund, the Lothian Buses Pension Fund and the Scottish Homes Pension Fund which had now been considered by Audit Scotland. The International Standard on Auditing (ISA) 260 requires the External Auditor to communicate their findings to those charged with governance of the funds.

Decision

1) To note the External Auditor's report on the audit of the Annual Report for the year ended 31 March 2014 for the Lothian Pension Fund, the Lothian Buses Pension Fund and the Scottish Homes Pension Fund.

2) To note the Audited Annual Report 2014 for the Lothian Pension Fund, Lothian Buses Pension Fund and Scottish Homes Pension Fund.

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

4. Review of Investment Operations

A summary was provided on the key matters in relation to the investment controls and development of the in-house investment operations.

Decision

To note the progress made in relation to implementing the recommendations of the external consultant and in seeking Financial Conduct Authority (FCA) authorisation.

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

5. Pension Fund Investment Staffing

The risk from the lack of remuneration benchmarking and short notice periods for investment staff was highlighted and potential options to manage the risk were outlined. The Pensions Committee of 23 September 2014 would be asked to make a decision on this issue.

Decision

To note the report.

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

6. Audit of Foreign Exchange Transaction Costs

Details were provided on the audit of foreign exchange (FX) transaction costs for the period 1 April 2013 to 31 March 2014. Recommendations were outlined on possible future actions to further improve the control of costs.

Decision

To note the report.

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

7. Pensions Administration Data Quality

An update was given on a range of initiatives which were being utilised to improve the flow of data from employers with the aim of enhancing the quality of pension administration membership record data.

Decision

To note the report.

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

8. Prevention of Fraudulent Pension Payments

Details were provided on the ongoing work in fraud prevention initiatives as an integral part of the control environment and the overall management of risk.

Decision

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

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

9. Irrecoverable Overpayment of Pensions

An update was provided on pension overpayments, during the period 1 September 2013 to 31 August 2014, which had been deemed irrecoverable by the Director of Corporate Governance, in accordance with the Council's "Scheme of Delegation to Officers".

Decision

To note that the total value of pension overpayments written off between 1 September 2013 and 31 August 2014 was £2,287.64.

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

10. Risk Management

A summary was provided on the Lothian Pensions Fund's risk management procedures, including details on the operational risk register and quarterly risk overview.

Decision

To note the Quarterly Risk Overview.

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

Pensions Audit Sub Committee

2.30 p.m., Tuesday, 16 December 2014

Agenda Planning

Item number	5.1
Report number	
Executive/routine	
Wards	All

Executive summary

This document provides Committee with an indication of the agenda for future meetings of the Pensions Committee and Audit Sub Committee. It also provides a more general overview of the current cycle of papers for the Committee.

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.

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

Agenda Planning

Recommendations

1.1 That Committee notes the agenda planning document.

Background

2.1 In order for the Pensions Committee and Consultative Panel to gain an overview of the content of the Committee Cycle it was agreed that an agenda planning document be submitted each quarter.

Main report

3.1 Based on the Committee cycle and the current position, the proposed agendas for the next two meetings are set out below.

March 2015

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

- Audit plans and reports (internal and external)
- Pension Fund Governance
- Funding Strategy Statement
- 2014 Actuarial Valuation for Lothian Pension Fund
- 2014 Actuarial Valuation for Lothian Buses Pension Fund
- 2014-17 Service Plan update
- 2015-18 Service Plan and Budget
- Policy Reviews (if any)
- Training Activity (Committee and Panel)
- Internal Investment Risks & Controls (progress in implementing recommendations from external assessment of controls, including FCA and staffing matters)
- Update on Employer Admissions in Lothian Pension Fund
- Risk management summary

3.2 It is proposed that the Pensions Audit Sub-Committee does not meet in March 2015. Audit plans for 2015/16 will be developed in consultation with the Convener of the Audit Sub-Committee before consideration by the Pensions Committee.

June 2015

The following papers are currently scheduled for the Pensions Audit Sub-Committee and Pensions Committee meeting in June 2015:

Pensions Committee	Audit Sub Committee
• Referrals/recommendations from the Pensions Audit-Sub Committee • Lothian Pension Fund Annual Report (& Accounts) Unaudited • Statement of Investment Principles • Investment Strategy Panel Activity • Annual Investment and Funding Update – LPF/LBPF/SHPF • Risk management summary	• Lothian Pension Fund Annual Report (& Accounts) Unaudited • Risk management summary

Measures of success

4.1 The Committee and Consultative Panel will have greater clarity regarding the content of the Committee Cycle.

Financial impact

5.1 None.

Risk, policy, compliance and governance impact

6.1 There is no direct impact as a result of this report. The forward planning of the Committees' agendas should facilitate improved risk management and governance for the pension funds.

Equalities impact

7.1 None.

Sustainability impact

8.1 None.

Consultation and engagement

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

Background reading / external references

None.

Alastair Maclean

Director of Corporate Governance

Struan Fairbairn, Legal & Risk Manager

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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	
Appendices	Appendix 1 - Agenda planning appendix.

Frequency	Pensions Committee	Audit Sub Committee	Month
Annually	Audit plans and reports (internal and external)	N/A - Draft audits and plan will be developed in consultation with the Convenor of the Audit Sub Committee.	March
	Service Plan and Budget	N/A	March
	Policies/Strategies/Training	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 and funding – LPF/LBPF/SHPF	N/A	June
	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	Delegated authorities: Write offs -	September
	N/A	Fraud Prevention	September
	Annual Performance & Benchmarking	N/A	September
	N/A	Audit of Foreign Exchange Transaction Costs	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
	N/A	Investment Income Review-Cross-Border withholding tax	December
	Environmental Social and Governance Activity	N/A	December
	N/A	Investment Controls & Compliance	December

Frequency	Pensions Committee	Audit Sub Committee	Month
Semi Annually	Update on Employer Admissions in LPF	N/A	March & September
3 Times per year	Service Plan Update	N/A	March, September & December
	Referrals / recommendations from Pensions Audit-Sub	N/A	June, September & December
Quarterly	Risk management summary	Risk management summary	March, June, September and December
Every 3 years	Actuarial Valuation: LPF/LBPF/SHPF Funding Strategy Statement		December or March
As required	Delegated authorities (provider appointments)	N/A	
	Discretions (death grants etc.)	Audit reports	
	N/A	Internal Audit Reports	
	Regulatory Update	N/A	
	Investment Strategy Reviews (at least every 3 years)	N/A	
	N/A	Risk management (in depth review)	

Pensions Audit Sub Committee

2.30 p.m., Tuesday, 16 December 2014

Report by the External Auditor on the Annual Report 2014 of Lothian Pension Fund, Lothian Buses Pension Fund and Scottish Homes Pension Fund

Item number	5.2
Report number	
Wards	All

Executive summary

This report presents the External Auditor's Annual Report on the 2013/14 audit of the Lothian Pension Funds. The report from Audit Scotland is shown at Appendix 1. This includes commentary from the Investment & Pensions Service Manager as to planned management actions. The report will be presented to Committee by Stephen O'Hagan, Senior Audit Manager, Audit Scotland.

Audit Scotland has already provided "an unqualified opinion that the financial statements (of the Lothian Pension Fund, the Lothian Buses Pension Fund and the Scottish Homes Pension Fund) give a true and fair view of the transactions of the funds during the year ended 31 March 2014, and of the amount and disposition at that date of their assets and liabilities".

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	

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Report

Report by the External Auditor on the Annual Report 2014 of Lothian Pension Fund, Lothian Buses Pension Fund and Scottish Homes Pension Fund

Recommendations

1.1 Committee is requested to:

- note the Annual Report on the 2013/14 audit of the Lothian Pension Fund, Lothian Buses Pension Fund and Scottish Homes Pension Fund;
- note the Action Plan at Appendix II of the report and seek appropriate updates on progress;
- 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 2015;
- highlight any points that it would like to raise at the Pensions Committee on 17 December 2014.

Background

Unqualified audit opinion

2.1 Audit Scotland has already provided "an unqualified opinion that the financial statements (of the Lothian Pension Fund, Lothian Buses Pension Fund and Scottish Homes Pension Fund) give a true and fair view of the transactions of the funds during the year ended 31 March 2014, and of the amount and disposition at that date of their assets and liabilities".

Main report

Report on the 2013/14 audit by the External Auditor

3.1 The purpose of this report is to present the External Auditor's Annual Report on the 2013/14 audit of the Lothian Pension Funds. The report from Audit Scotland is shown at Appendix 1. This includes commentary from the Investment & Pensions Manager as to planned management actions. The report will be presented to Committee by Stephen O'Hagan, Senior Audit Manager, Audit Scotland.

3.2 In addition to members of the Pensions Committee and Pensions Audit Sub-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.

3.3 On pages 3 and 4 of the report, Audit Scotland has highlighted the financial position of Lothian Pension Fund at 31 March 2014, with 'net assets representing 80% of estimated promised retirement benefits'. It is important, however, to emphasise that a significant degree of caution should be applied to any assertion of funding level calculated on this basis. The figures are only prepared for the purposes of International Accounting Standard (IAS)26 and have no validity in other circumstances. In particular, it is not relevant for calculations undertaken for funding purposes. Financial positions for the Lothian Buses Pension Fund and Scottish Homes Pension Fund have been derived using the same methodology. The 2014 actuarial valuation process will assess the funding positions, for the purposes of setting employer contribution rates.

3.4 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 2015.

Measures of success

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

Financial impact

5.1 There are no financial implications arising directly from this report.

Risk, policy, compliance and governance impact

6.1 This annual report summarises the opinions and conclusions of Audit Scotland, in accordance with International Standards on Auditing (UK and Ireland) and the principles contained in the Code of Audit Practice issued by Audit Scotland in May 2011. Appendix I (of the Audit Scotland report) sets out the significant audit risks identified at the planning stage and how the auditor addressed each risk in arriving at his opinion on the financial statements. Appendix II is an action plan setting out the high level risks identified from the audit. Officers have considered the issues and agreed to take the specific steps in the column headed "Management action/response".

Equalities impact

7.1 There are no adverse equalities impacts arising from this report.

Sustainability impact

8.1 There are no adverse sustainability impacts arising from this report.

Consultation and engagement

9.1 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

Alastair Maclean

Director of Corporate Governance

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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	Audit Scotland report on the 2013/14 audit of Lothian Pension Funds

Lothian Pension Funds

Annual report on the 2013/14 audit

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

October 2014

Contents

Key contacts

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Key messages

Financial statements	• We have given an unqualified opinion on the financial statements of Lothian Pension Funds for 2013/14.
Financial position	• Lothian Pension Fund (main fund) had net assets of £4,377 million at 31 March 2014. The actuarial value of estimated promised retirement benefits at 31 March 2014 was £5,483 million. • The net assets of the Lothian Buses and the Scottish Homes Pension Funds were £337 million and £136 million, respectively, at 31 March 2014. The actuarial value of estimated promised retirement benefits at 31 March 2014 for Buses and Homes were £358 million and £138 million, respectively.
Governance & accountability	• The Funds have effective governance arrangements that include a Pensions Committee and a Pensions Audit Sub-Committee. An Investment Strategy Panel provides advice to City of Edinburgh Council's Director of Corporate Governance who has delegated authority for implementing the Funds' investment strategy.
Best Value, use of resources & performance	• Investment performance for the Funds is measured against benchmarks which were agreed by the Pensions Committee in December 2012. For all 3 funds the return on investments for the 2013/14 financial year has met or exceeded these benchmarks.
Outlook	• The most significant area of risk for the Funds concerns investment returns. Although there was a resurgence of financial markets during the financial year, the longer term economic enviroment of weak growth and continuing European fiscal deficits, means that investment performance will be a key issue going forward.

Financial statements

We have given an unqualified audit opinion that the financial statements of the Lothian Pension Funds for 2013/14 give a true and fair view of the financial transactions of the funds during the year ended 31 March 2014, and of the amount and disposition at that date of their assets and liabilities.

Financial position – Funding

Lothian Pension Fund had net assets of £4,377 million as at 31 March 2014. The actuarial value of promised retirement benefits at 31 March 2014 has been estimated by the actuary as £5,483 million. This actuarial estimate would mean a net liability of £1,106 million as at 31 March 2014 (£1,366 million as at 31 March 2013), with net assets representing 80% of estimated promised retirement benefits.

The estimated liability prepared by the actuary is not a full actuarial statement but rather a figure prepared for the purposes of statutory accounting.

The Lothian Buses Pension Fund was closed to new members in 2008. As at 31 March 2014, the Fund had net assets of £337 million. The actuarial value of promised retirement benefits at the accounting date has been estimated by the actuary as £358 million. The actuarial estimate would mean a net liability of £21 million with net assets representing 94% of estimated promised retirement benefits.

As at 31 March 2014, the Scottish Homes Pension Fund had net assets of £136 million. The actuarial value of promised retirement benefits at the accounting date has been estimated by the actuary as £138 million. The actuarial estimate would mean a net liability of £2 million, with net assets representing 99% of estimated promised retirement benefits. There are no active members of the fund, while the Scottish Government acts as guarantor.

The actuary undertakes a triennial valuation on each fund to calculate funding levels, and this is used to set employer contribution rates. At the last triennial revaluations in 2011, the funding levels for the main Pension Fund, Lothian Buses Pension Fund and Scottish Homes Pension Fund were 96%, 112% and 86% respectively. The 2014 triennial valuation is currently being prepared by the actuary and will be used to set contribution rates from April 2015.

Financial position – Administration

The Funds' actual expenditure compared to the approved budget disclosed an underspend of £0.959 million for the year to 31 March 2014, mainly due to an underspend of £0.381 million on investment managers fees.

Governance and accountability

The Funds have effective governance arrangements that include a Pensions Committee supported by a Pensions Audit Sub-

Committee and an advisory Consultative Panel with representatives from employers, pensioners and trade unions.

We also concluded that the Pension Funds have adequate internal controls (including internal audit) and satisfactory arrangements for the prevention and detection of fraud and corruption.

Best Value and performance

The performance of the Funds' investments is measured against benchmarks agreed by the Pensions Committee in 2012. Three different benchmarks were approved to accommodate the different asset types held by the Funds. For 2013/14 investment performance for Lothian Pension Fund was 1.6% ahead of the benchmark level (Lothian Buses was 3.8% ahead, Scottish Homes matched the benchmark). The longer term periods of assessment used by the Funds outperformed benchmark levels by a smaller margin for Lothian Pension Fund and Lothian Buses Pension Fund with Scottish Homes again matching the benchmark.

Outlook

Global financial markets have provided positive returns for investors in 2013/14, however sustaining this performance in the long term will be challenging. A combination of factors will likely impact on the performance of investments; fragile European public finances; the prospects of monetary policy tightening in the US and a loss of economic momentum, particularly in China where policy makers are grappling with high levels of credit. With investment performance key to the funding position of the LGPS, this may impact on employer contributions in the longer term.

The Public Services Pensions Act 2013 passed by UK parliament will mean changes to the way local government pension funds operate and pension benefits are accrued by members. Changes to meet the new Act are required to be implemented by 6 April 2015.

Parts of the changes mean that the accrual of benefits by members will now be provided for on a CARE (Career Averaged Revalued Earnings) basis. Member's benefits accrued after 1 April 2015 will be based on a fraction of their pensionable pay for every year they are a member of the LGPS. These changes will entail additional administrative and record keeping obligations being placed on employers and Lothian Pension Fund in determining member benefits. The Funds' pension administration system is being developed to address this challenge.

The triennial valuation at 31 March 2014 which will set the employer contribution rates for the next three years starting from 1 April 2015 will be finalised in early 2015. Lothian Pension Funds' expectation is that the monetary value of its deficit will have increased, driven by the low gilt yields serving to reduce the discount.

The implementation of the investment strategies 2012-2017 continue with the key focus of reducing risk primarily through changing the Funds' equity holdings, or reducing these and moving into index-linked assets and alternatives, where appropriate.

Introduction

1. This report is a summary of our findings arising from the 2013/14 audit of the Lothian Pension Funds. The purpose of the annual audit report is to summarise the auditor's opinions and conclusions, and to report any significant issues arising from the audit. The report is divided into sections which reflect our public sector audit model.

2. Our responsibility, as the external auditor of the Lothian Pension Funds, is to undertake our audit in accordance with International Standards on Auditing (UK and Ireland) and the principles contained in the Code of Audit Practice issued by Audit Scotland in May 2011.

3. The management of the Lothian Pension Funds is responsible for:

   - preparing financial statements which give a true and fair view
   - implementing appropriate internal control systems
   - putting in place proper arrangements for the conduct of its affairs
   - ensuring that the financial position is soundly based.

4. This report is addressed to the members of City of Edinburgh Council and the Controller of Audit and should form the basis of discussions with the Pensions Committee as soon as possible after it has been issued. Reports should be made available to stakeholders and the public, as audit is an essential element of accountability and the process of public reporting.

5. This report will be published on our website after it has been considered by the Pensions Committee. The information in this report may be used for the Accounts Commission's annual overview report on local authority audits. The overview report is published and presented to the Local Government and Regeneration Committee of the Scottish Parliament.

6. The concept of audit risk is of key importance to the audit process. During the planning stage of our audit we identified a number of key audit risks which involved the highest level of judgement and impact on the financial statements. We set out in our annual audit plan the related sources of assurance and the audit work we proposed to undertake to secure appropriate levels of assurance. Appendix I sets out the significant audit risks identified at the planning stage and how we addressed each risk in arriving at our opinion on the financial statements.

7. Appendix II 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 "Management action/response".

8. We recognise that not all risks can be eliminated or even

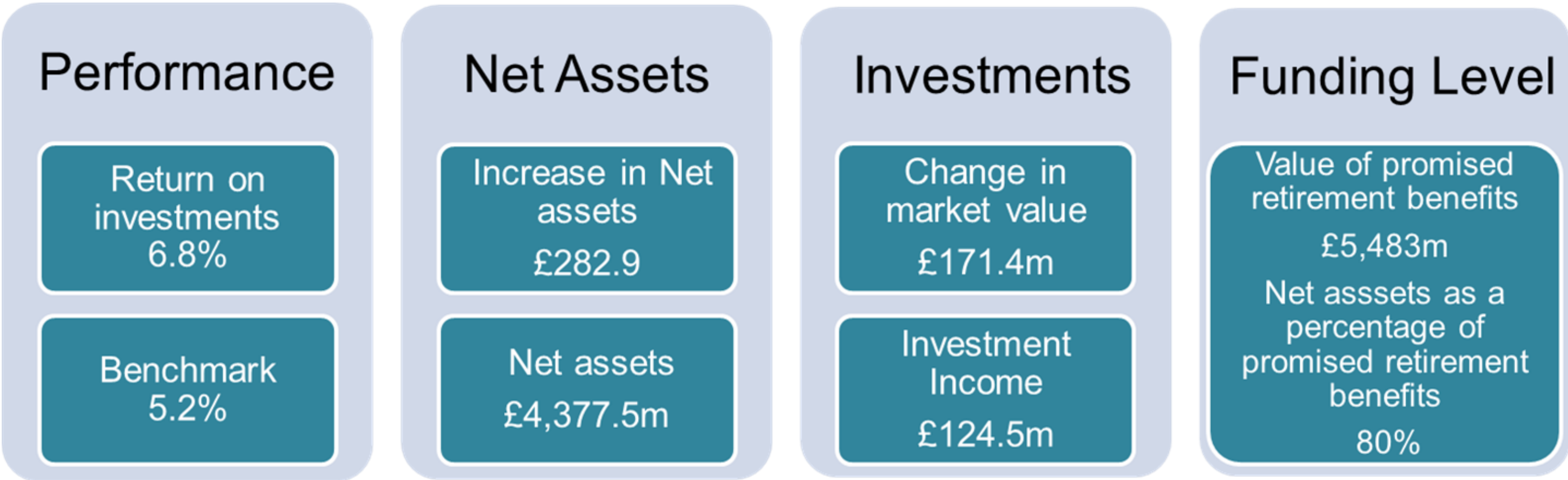
minimised. What is important is that Lothian Pension Funds understands its risks and has arrangements in place to manage these risks. The Pension Funds and the Proper Officer should ensure that they are satisfied with proposed management action and have a mechanism in place to assess progress and monitor outcomes.

9. We have included in this report only those matters that have come to our attention as a result of our normal audit procedures; consequently, our comments should not be regarded as a comprehensive record of all deficiencies that may exist or improvements that could be made.

Acknowledgement

10. The co-operation and assistance given to us by officers during the conduct of our audit is gratefully acknowledged.

Financial statements



Source: Lothian Pension Funds Financial Statements – main fund data

Audit opinion

11. We have given an unqualified opinion that the financial statements of the Lothian Pension Funds for 2013/14 give a true and fair view of the financial transactions of the funds during the year ended 31 March 2014, and of the amount and disposition at that date of their assets and liabilities.

Other information published with the financial statements

12. Auditors review and report on other information published with the financial statements, including the sections titled Review of the Year, How the Fund Works, Investments and Financial Performance, the Annual Governance Statement and the Governance Compliance Statement. We have nothing to report in respect of these statements.

Legality

13. Through our planned audit work we consider the legality of the Pension Funds' 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 are 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.

Accounting issues arising

Presentational and monetary adjustments

14. A number of presentational adjustments were identified during the course of the audit. These were discussed and agreed with management who agreed to amend the unaudited financial statements.

15. Additionally, there was one monetary error identified during the course of the audit, relating to the accounting for a rebate of custodian system fees received. Paragraph 24 of this report provides more details on this issue. Officers considered this error to be immaterial to the financial statements and we concurred with this view. No amendment was made to the accounts as a consequence.

16. Local authority bodies in Scotland are required to follow the Code of Practice on Local Authority Accounting in the United Kingdom 2013/14, supported by International Financial Reporting Standards (IFRS). We concluded that the financial statements had been prepared in accordance with extant guidance.

Report to those charged with governance

17. We presented our report to those charged with governance (ISA 260) to the Pensions Audit Sub-Committee, on 22 September 2014, and the Pensions Committee on 23 September 2014. The primary purpose of that report is to communicate the significant findings arising from our audit prior to finalisation of the independent auditor's report. The main points are set out in the following paragraphs.

18. **Investment Management Expenses**: In 2012/13 we highlighted that investment management expenses disclosed in the Pension Fund Accounts and supporting notes did not fully reflect the fees charged. CIPFA recently published guidance on accounting for pension scheme management costs, to assist fund comparability.

19. Whilst the June 2014 publication date for this guidance made it too late in the accounts preparation cycle for pension funds generally to apply it in 2013/14, Lothian Pension Funds' officers had been working closely with CIPFA on the development of the guidance.

20. Information from investment managers allowed the fund to apply the principles of the CIPFA guidance and recognise these particular investment management costs as a cost in the fund account, rather than a reduction in the change in market value of investments. As part of our audit we reviewed the reasonableness of the methodology applied and sample checked the calculations undertaken to determine the investment management costs.

Refer to Action Plan Point 1

21. **Additional Voluntary Contributions (AVCs):** The financial statements include disclosure notes setting out AVCs made by employees in the Lothian Pension Fund and Lothian Buses Pension Fund. However, the notes did not separately identify the contributions and fund values between funds. Officers sought the required information from fund managers to facilitate reporting of additional voluntary contributions separately for the Lothian and Lothian Buses Pension Funds. This was subsequently provided but too late for inclusion in the 2013/14 accounts. Suitable assurance has been obtained for 2014/15.

22. Further narrative was added to accompany the AVC notes in each Fund. It emphasised that the sums presented relate to both Lothian Pension Fund and Lothian Buses Pension Fund members.

23. **Group Transfer:** The Lothian Pension Fund account disclosed a group transfer out of £5.287 million. The transfer related to 37 employees of the Edinburgh College of Art who transferred employment to the University of Edinburgh in August 2011. Unlike individual transfers, which are recognised in the fund accounts on a cash basis, group transfers should be accounted for on an accruals basis. However, no accrual was included in the accounts for 2011/12 or 2012/13 as the respective actuaries had not agreed the transfer value. Further narrative was included in Lothian Pension Fund account to provide detail on the characteristics of this transfer.

24. **Custodian Fees:** During 2013/14 it was highlighted to officers by the custodian system provider, Northern Trust, that the Funds were due a rebate on custodian fees previously paid. The rebate due to Lothian Pension Fund and Lothian Buses Pension Fund was £0.219 million and £0.021 million respectively. Although the discount partly related to fees paid in prior years (£0.131 million for Lothian and £0.015 million for Buses), the rebate amounts were recognised fully in the current financial year. This accounting treatment was assessed as having no material effect on the financial statements and we concurred with this assessment.

25. **Unfunded Pension Payments:** The unaudited Lothian Pension Fund Account included a debtor balance of £2.869 million on the balance sheet which related to unfunded benefit payments. These amounts were items such as the award of discretionary years, where the pension costs are met by the

individual employers. In prior years, they were recognised on the City of Edinburgh Council ledger, however following system access changes they were posted to the Pension Fund ledger for 2013/14.

26. The debtors balance on the Lothian Pension Fund account was reduced by £2.869 million to recognise this is properly a City of Edinburgh Council debtor. A compensating increase of £2.869 million was made to the City of Edinburgh holding account balance, to recognise the pay over of the £2.869 million is no longer due. The impact of these adjustments on the current assets in the pension fund accounts was nil.

Outlook

27. The financial statements of the Pension Funds are prepared in accordance with the Code of Practice on Local Authority Accounting in the United Kingdom (the Code). The main new standards to be adopted in 2014/15 include:

- IFRS 13 Fair value measurement
- IAS 32 Financial Instruments: Presentation
- Annual improvements to IFRSs 2009-2011 cycle

28. These new standards are not expected to have a significant impact on the Pension Funds financial statements.

29. The revised Local Authority Accounts (Scotland) Regulations 2014 apply to financial years 2014/15 onwards. The regulations set out in more detail what is required in respect of financial management and internal control, and in respect of the annual accounts themselves. The significant changes include:

- the requirement for the unaudited accounts to be considered by the Pensions Committee. This can take place following submission to the auditor and up to 31 August if necessary. In addition the audited accounts must be considered and approved for signature by the Pensions Committee by 30 September with publication on the Authority's website by 31 October.
- the Pensions Committee will be required to carry out an annual review of the fund's system of internal control, together with the requirement to approve an annual governance statement or equivalent.
- the Pensions Committee will be required to consider the efficiency and effectiveness of internal audit.

30. The Pension Funds' already undertake a number of the revised regulation requirements. Going forward, the Funds will need to ensure that all the conditions of the revised regulations are implemented.

Financial position

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

32. 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.

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

Financial results

34. Lothian Pension Funds prepares an annual administration budget for the delivery of its service plan to members. This budget for administration related costs is routinely reported to the Pensions Committee, where any variances are reviewed.

35. As detailed in the 2013/14 financial statements, there was a total underspend of £0.959 million against budgeted administration costs for the financial year. The most significant element of underspend was down to savings realised through the use of in-house investment management.

Funding position

36. The most recent triennial valuation for Lothian Pension Funds was reported in February 2012. The report highlighted that the main fund's assets valued at 31 March 2011 were sufficient to meet 96% of its liabilities accrued up to that date, resulting in a funding shortfall of £142 million. This represents an improved position from the previous triennial valuation (as at March 2008) which reported a funding position of 85% (a funding shortfall of £524 million).

37. The movement in funding position has been significantly influenced by recent changes including pension increases being linked to the Consumer Price Index and the way life expectancy is treated. These movements are summarised in **Exhibit 1**.

Exhibit 1: Movement in main fund valuations 2008 to 2011

Fund Details	2008 £million	2011 £million
Assets	2,903	3,477
Liabilities	(3,427)	(3,619)
Net Liability	(524)	(142)
Funding Level	85%	96%

Source: actuary's valuations from 2008 and 2011

38. The funding levels calculated at the last triennial revaluations in 2011 for the Lothian Buses Pension Fund and Scottish Homes Pension Fund were 112% and 86% respectively. The 2014 triennial valuations are currently being prepared by the actuary and will be used to set contribution rates from April 2015.

39. The actuarial values of promised retirement benefits for each fund are calculated annually by the actuary for the purposes of international accounting standards. These annual values are not relevant for calculating funding levels or setting employer contribution levels.

40. The Lothian Pension Fund actuarial annual statement at 31 March 2014 estimated a value of promised retirement benefits as £5,483 million (2012/13: £4,946 million). Net assets of £4,377 million at 31 March 2014 were sufficient to meet 80% of this value. This increase in the net liability is mainly due to a fall in real bond yields. The liability is not a full actuarial valuation, but an estimate of the present value of the future liabilities of the fund, based on the fund actuary's assumptions regarding the future discount rate, longevity of members and rate of inflation.

41. Based on the 31 March 2014 actuarial annual statement for the Lothian Buses Pension Fund, the net assets of £337 million represent 94% of existing promised benefits of £358 million. This fund stopped admitting new members in 2008; consequently the long term trend will be for the number of active members to decrease.

42. The Scottish Homes Pension Fund has no active members contributing to the fund. Based on the 2013/14 actuarial statement, net assets of £136 million at 31 March 2014 represent 99% of estimated promised retirement benefits of £138 million. As guarantor of the fund, the Scottish Government is liable to meet any shortfall in funding.

43. The Funds' actuary carried out a modelling exercise during 2012/13 to provide updated cash flow projections based on Fund membership at 31 March 2013. This work produced a contribution stability mechanism, designed to provide certainty of pension contributions for certain Fund employers for future years, whilst still maintaining appropriate funding levels to the Fund.

44. The modelling exercise also confirmed that Lothian Pension

Fund is expected to move to a negative cash flow position in the near future. The Fund will use investment income to pay pensions when this occurs, rather than reinvesting. As identified in our Annual Audit Plan, the Funds are taking action to monitor the membership profile over the long term.

Outlook

45. The longer term outlook for the Funds will remain challenging as significant budget reductions continue to be required by Local Government employers in future years. Member bodies are likely to seek to deliver efficiencies through reductions in staffing levels and recruitment, which would impact on the number of active members in Lothian Pension Fund. Reductions in the number of active members will place a greater emphasis of the Funds' investments for the generation of income to meet payments for members' benefits.

46. In the short-term, the introduction of auto enrolment has contributed to an increase in active membership numbers from 28,869 to 30,622. These numbers may increase further as other employers progress through the auto enrolment process.

47. In addition to the Funds' obligations to members, their financial position is determined by the performance of their investments. In the current environment of low Bond yields and interest rates, obtaining the required rates of return to sustain the financial position will require careful consideration of the types of investments that are made. Any investments in alternative products by the Funds will require vigilant management to limit their exposure to any downside risks and ensure a reliable rate of return.

Governance and accountability

48. Members of the Pensions Committee and the Pensions and Accounting Manager are responsible for establishing arrangements for ensuring the proper conduct of the affairs of the Funds and for monitoring the adequacy and effectiveness of these arrangements.

Corporate governance

49. The corporate governance framework for the Funds is centred on the Pensions Committee which is supported by a Pensions Audit Sub-Committee. City of Edinburgh Council's Director of Corporate Governance has delegated authority for the implementation of the Funds' investment strategy. An Investment Strategy Panel provides advice on these matters.

50. Based on our observations and audit work our overall conclusion is that the governance arrangements within the Funds are operating effectively.

Governance processes and committees

51. City of Edinburgh Council acts as the administering authority for the Funds. It is responsible for managing and administering the scheme for scheduled and admitted bodies.

52. The Council has delegated the administration, management and investment of the Pension Funds to the Pensions Committee. The committee comprises councillors from City of Edinburgh Council and representatives from employers and members of the schemes.

53. A Consultative Panel exists to enhance participation in the development and scrutiny of matters relating to the Pension Fund. It 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.

54. Day to day administration of the Funds 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. However for the Lothian Pension Funds, this Section 95 responsibility has been delegated to the Pensions and Accounting Manager.

Investment Operations

55. A review of investment governance arrangements of the pension funds was instigated in December 2013 at the request of the Director of Corporate Governance. External consultants were appointed to review investment operations, particularly those relating to internally managed investments.

Investment controls

56. The review by the external consultants concluded that the existing systems and controls were generally sufficient for the Funds' current investment activities. A number of key risks were identified including those around the investment staff remuneration and retention policies. It was noted by the consultants that the Funds did not externally benchmark salaries and that notice period provisions in investment staff contracts were not in line with market practice. The consultants also noted that adherence to the council's human resources policies and procedures limited the Funds' ability to mitigate these staffing risks.

57. One of the options identified was the creation of a special purpose vehicle separate from the council which would allow the board of this vehicle to decide on appropriate terms and conditions. The vehicle would be wholly owned by the council. At the September 2014 meeting of the Pensions Committee members agreed in principle that a special purposes vehicle should be established. This option was subsequently approved by City of Edinburgh Council.

Financial Conduct Authority (FCA) authorisation

58. On 24 March 2014, the Pensions Committee agreed that the Lothian Pension Funds would seek Financial Conduct Authority (FCA) authorisation.

59. The purpose of seeking this authorisation is to

- further strengthen the governance of the investment activities of the pension funds,
- ensure that the current activities of the Funds' investment function continue to be carried out within the appropriate regulatory regime
- further facilitate the ongoing development of this team to generate further cost efficiencies and savings for the benefit of the stakeholders of the Funds.

60. At their October 2014 meeting, City of Edinburgh Council approved the creation of one or, if appropriate following legal and tax advice, two special purpose vehicles wholly owned and controlled by City of Edinburgh Council for the purposes of:

- seeking Financial Conduct Authority (FCA) authorisation for the activities of this team
- directly employing certain key staff associated with Lothian Pension Fund's investment function.

61. The costs and efficiencies generated by these special purpose vehicles will be borne by and attributed to the pension funds.

62. Creation of the special purpose vehicles will have a number of implications for the audit of the pension funds in future years. The impact of these changes will be considered as part of the

planning process for the 2014/15 audit of the Pension Funds.

Governance Compliance Statement

63. Pension administration regulations require an administering authority to prepare and publish a governance compliance statement to measure their pension fund's governance arrangements against the standards set out in the guidance issued by the Scottish Ministers. Having reviewed the governance compliance statement we are satisfied that it complies with the guidance issued by the Scottish Ministers.

64. The governance structures have been seen to be working well with no issues with regard to openness, reporting or scrutiny. The information reported in the governance compliance statement is consistent with our knowledge and understanding of the Funds' governance arrangements, based on our audit knowledge, attendance at meetings, and review of papers and minutes.

65. The Code of Practice on local authority accounting in the United Kingdom 2014/15 has been amended to require pension fund bodies to include either:

- a separate statement on system of internal financial control (SSIFC), or
- additional disclosures, reports or statements as necessary in order to meet the requirements of that statement.

66. The Funds have addressed this in 2013/14 and in previous years by including an Annual Governance Statement in their annual report as a matter of best practice. This statement has been based primarily on the content of the council's Annual Governance Statement. Whilst some of the content within the council's statement is pertinent to the Funds, there are aspects which are of less relevance.

Refer to Action Plan Point 2

Internal control

67. 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 is also informed by an assessment of risk and the activities of internal audit.

68. The Funds' financial systems are run alongside those of the City of Edinburgh Council and some of the council's 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 2013/14.

69. As part of our work we also took assurance from key controls within the Funds' financial systems. From our work on these

systems, no significant control weaknesses were identified.

Internal audit

70. Internal audit is an important element of the Funds' governance structure. The internal audit service is provided by City of Edinburgh Council via a co-source arrangement with PricewaterhouseCoopers.

71. We reviewed internal audit at the planning stage of our audit and concluded that they operated in accordance with the Public Service Internal Audit Standards and had sound documentation standards and reporting procedures in place.

72. During 2013/14, internal audit carried out a review of the implementation of the Funds' new payroll module. The work concluded that the project was being appropriately managed with sufficient governance and risk management controls and safeguards being in place. This work was considered in our assessment of the internal controls put in place by the Funds.

73. The Public Sector Internal Audit Standards require internal audit to deliver an annual internal audit opinion and report that can be used by the organisation to inform its governance statement. The annual internal audit opinion should conclude on the overall adequacy and effectiveness of the organisation's framework of governance, risk management and control. It should also contain certain information, including a summary of the work that supports the opinion; a statement on conformance with the Public Sector Internal Audit Standards and the results of the quality assurance and improvement programme.

74. Internal audit provided an opinion in compliance with the above requirements, and it was presented to the Pensions Committee on 17 June 2014 along with other key assurance statements, as part of the consideration of the unaudited financial statements.

Arrangements for the prevention and detection of fraud

75. The Funds comply with the relevant fraud and irregularity policies of Edinburgh City Council and these have been reviewed as part of the council wide audit. Overall we concluded that arrangements for the prevention and detection of fraud are adequate and there are no issues which we require to include in this report.

76. The Funds participate in the National Fraud Initiative (NFI). The NFI uses electronic data analysis techniques to compare information held on individuals by different public sector bodies and different financial systems, to identify data matches that might indicate the existence of fraud or error.

77. As part of our local audit work we monitor City of Edinburgh

Council's approach to participation in NFI both in terms of the submission of the required datasets and their approach to and progress investigating the subsequent data matches. A total of 1,086 pension matches were identified from the most recently completed 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.

78. During 2013/14, the Pension and Investment Division officers were engaged in investigating matches and resolving outcomes. The Division identified overpayments £0.3 million from the matches reviewed, with these amounts currently being recovered.

Arrangements for maintaining standards of conduct and the prevention and detection of corruption

79. 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.

80. Pension staff, as employees of the council, are bound by the council's employee Code of Conduct. Additionally, committee members are expected to have high standards of character and personal conduct and must declare their interests where relevant. Furthermore, committee members receive training on standards in public life.

Outlook

81. Progress continues to be made by the Funds towards the implementation of the new Local Government Pensions Scheme (LGPS) in Scotland.

82. There are a number of challenges for the Funds including the move to pensions on a career average basis. 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 not only increase administrative workload initially, but will also undoubtedly generate many more enquiries from fund members seeking clarification on their benefits on an ongoing basis.

83. Each pension fund in Scotland will also be required to establish a Pension Board by 1 April 2015 which will be responsible for assisting with compliance with scheme regulations and the requirements of the pensions regulator.

84. Regular updates have been provided to the pensions committee on progress being made with implementing the changes, however, the timescales involved are short and there is a risk that not all the required changes will be made in time.

Refer to Action Plan Point 3

Best value, performance and use of resources

Best Value

85. The Pension Funds have not been subject to a Best Value review; however, it is covered by the overall Best Value arrangements of the administering authority.

Performance

Investment Performance

86. Investments are managed both by external fund mangers and the Funds' internal investment management team. Through the use of mandates, responsibility for the management of the Funds' investments has been divided up. **Exhibit 2** shows the allocation of investments to fund managers for Lothian Pension Fund as at 31 March 2014.

87. Approximately 45% of the Lothian Buses Pension Fund is managed by in-house investment mangers, with the remainder allocated between 2 separate external investment managers.

88. The Scottish Homes Pension Fund investments are managed exclusively by external investment managers. The Fund's equity and bond investments account for 95% of its assets at 31 March 2014. These have been managed passively by external investments managers, State Street, since 2010.

Exhibit 2: Fund managers' allocation2013-14 (main fund)

Fund Manager	Market Value £'000	% of Total Fund Value
Ballie Gifford	152,847	3.5
Cantillon	238,423	5.5
Harris	175,955	4.1
Invesco	140,806	3.2
In-house Investment Managers	2,781,112	64.1
Mondrian	92,455	2.1
Nordea	163,920	3.8
Standard Life	322,037	7.4
Rogge	184,569	4.2
UBS	91,186	2.1
Total	4,343,310	100

Source: Lothian Pension Fund audited financial statements 2013/14

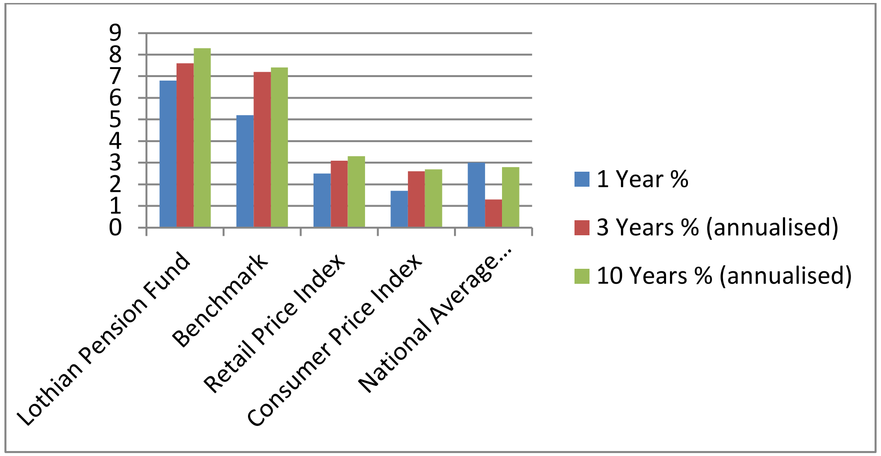
89. The main mechanism for measuring investment performance is through an analysis of the returns achieved by each of the Funds' fund managers. Each active Investment Manager has a defined performance benchmark and objective, against which performance will be measured. Their performance, in terms of achieving benchmarks, is subject to independent verification by an external specialist provider and is regularly reported to the pensions committee and investment strategy panel.

90. Investment returns of Lothian Pension Fund have outperformed benchmark targets over the short, medium and longer term, as illustrated in **Exhibit 3**. The table also shows that over a period of one, three and ten years the pension fund has outperformed measures of inflation i.e. the consumer price index, the retail price index and national average earnings.

91. Lothian Buses Pension Fund investment returns exceeded the required performance benchmark levels for 2013/14. The portfolio as a whole made returns of 8.9% against the benchmark target of 5.1%.

92. Scottish Homes Pension Fund investment returns met the required performance benchmark levels for 2013/14 of 2.1%. As described at paragraph 86, these are managed passively.

Exhibit 3: Investment Performance – Lothian Pension Fund



Source: Pensions Committee, Investment Performance Update, June 2014

Administration performance

93. The Funds' Administration Strategy was approved by the Pensions and Trusts Committee in March 2010. A revised strategy has since been approved by the committee in September 2013. It contains the standards which are required of the participating employers to ensure that the Funds meet their statutory obligations and are able to deliver services efficiently. The strategy contains a variety of performance measures against which the Funds and the participating employers are assessed.

94. In accordance with Regulation 60A of the LGPS

(Administration) (Scotland) Regulations 2008, the Funds' annual report discloses performance against the measures detailed in the Pension Administration Strategy. In relation to 2013/14 the Funds' performance was broadly in line with the annual targets set. Two targets – concerning stakeholder satisfaction and employer contributions payments - were narrowly missed.

Investment strategies

95. The Funds' investment strategies 2012-17, as agreed by the Pensions Committee in October 2012, have continued to be implemented during 2013/14. The key objective of the Funds' investment strategies is to reduce risk. For the main Fund and Lothian Buses Pension Fund, this has been progressed in 2013/14 through changes within equity portfolios to equities with less volatility, along with an increased exposure to index-linked assets and alternatives.

96. For alternatives, new investments have been made in the main fund, however, there has only been a small change in the percentage of the fund assets in alternatives because of the growth of the fund size. For Lothian Buses, increasing their exposure to alternatives is dependent on identifying attractive opportunities with the fund continuing to appraise investment opportunities.

97. For the Scottish Homes Pension Fund, the strategy has been to reduce the allocation to equities and property and increase the allocation to bonds. In 2013/14, as the actual funding level moved closer to the target funding level, the long term strategy was accelerated which resulted in the current and long term strategies matching.

National performance reports

98. 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 4.**

Exhibit 4: A selection of National Performance Reports 2013/14

Report	Key messages
How Councils Work – Charging for Services: Are You Getting It Right?	Councils should have clear policies in place for charging and concessions and councillors should have a lead role in determining these policies
Overview of Local Government in Scotland 2013/14	Underlines the need for councillors to maintain a good understanding of the rapidly changing economic, social and political context.
How Councils Work – Option Appraisals: Are You Getting It Right?	Councillors have a crucial role in option appraisals.

Appendix I – Significant audit risks

The table below sets out the key audit risks identified at the planning stage and how we addressed each risk in arriving at our opinion on the financial statements.

Audit Risk	Assurance procedure
Investment Manager Expenses Investment management expenses disclosed in the Funds' accounts and supporting notes do not currently reflect the full amount of investment management fees charged. Fees deducted from capital values are not shown. **Risk:** *members cannot gauge whether best value is being obtained.*	We reviewed the Funds' approach to investment manager fees deducted from capital against the final issued guidance ***** during our work on the 2013/14 financial statements. *******The guidance was issued following the preparation of the financial statements (June 2014), however the Funds' officers had been working closely with CIPFA during the development of this guidance.*
Payroll System Migration A new payroll system was implemented during the year. The system is integrated with the pre-existing pension administration system ***Risk***: *the new payroll system is not implemented with the necessary controls to ensure pension payments are processed in a secure and accurate manner*	Internal Audit has performed a review of the project, considering whether it was appropriately managed with sufficient governance and risk management controls and safeguards being in place. There were no critical issues identified from the report, which was considered during our work reviewing the internal controls put in place by the fund. Our review of the Funds' internal controls also considered the controls in place for the payroll system used previously by the funds (council system) which continued to be in use during the 2013/14 year. No significant control issues were identified from our work on the council's payroll system.

Appendix II – Action plan

Action plan point / para	Issue, risk and recommendation	Management action/response	Responsible officer	Target date
1 / 20	**Investment Management Expenses** As identified in our ISA260 report, the Funds have used information from Investment Fund Managers to calculate fees deducted from capital within their 2013/14 financial statements. ***Risk*** *The methodology applied for calculating investment management fees is not consistent with the guidance on Investment management fees issued by CIPFA in June 2014.The application of the methodology is inconsistent across funds throughout Scotland, preventing meaningful comparison.* **Recommendation** In relation to the 2014/15 financial statements, the Funds should review their approach to calculating management fees against the CIPFA guidance. Consideration should also be given to reviewing the approach taken against those of other Local Government Pension Schemes.	As the LPF Financial Controller "had been working closely with CIPFA during the development of this guidance", it is not envisaged that there should be any material issue of non-compliance with published CIPFA guidance 2014/15. This will, of course, be verified. LPF will be very interested in the comparability of investment management fee disclosures and consequent benchmarking with other LGPS funds. It may not be possible to ascertain this, however, prior to the determination of suitable methodology and completion by other Funds of the 2014/15 accounts.	Esmond Hamilton, **Financial Controller**	31 May 2015

Action plan point / para	Issue, risk and recommendation	Management action/response	Responsible officer	Target date
2 / 64	**Annual Governance Statement** The Funds have included an Annual Governance Statement in their annual report as a matter of best practice. This statement has been based primarily on the content of the council's Annual Governance Statement. Whilst some of the content within the council's statement is pertinent to the Funds, there are aspects which are of less relevance. **Risk** *There is a risk that the disclosures in the Annual Governance Statement are not focused on the governance arrangements of the Pension Funds.* **Recommendation** The Funds consider the current format and content of the Annual Governance Statement.	As is customary, the format and content of the Annual Governance Statement of the Lothian Pension Funds will be reviewed in the context of the Council's role as administering authority of the pension funds.	Clare Scott, **Investment & Pensions Service Manager**	31 May 2015

Action plan point / para	Issue, risk and recommendation	Management action/response	Responsible officer	Target date
3 / 82	**Pension Reform** Progress continues to be made by the Funds towards the implementation of the new Local Government Pensions Scheme (LGPS) in Scotland, including the introduction of career average pensions and Pension Boards by 1 April 2015. This is likely to increase administrative workload initially; generate more enquiries from fund members seeking clarification on their benefits on an ongoing basis, and require changes to the pension administration system. ***Risk*** *The Funds will have insufficient resource to deal with the increased workload leading to delays in providing information to members. In addition, there is a risk that not all the required changes will be in place by 1 April 2015.* **Recommendation** The funds should ensure that a comprehensive strategy is in place to manage the changes required by the Pensions Act.	The significant challenges represented by the implications of the LGPS 2015 are recognised. Project planning and preparatory work is underway to try to ensure successful implementation. Review of progress against targets will be undertaken	Clare Scott, **Investment & Pensions Service Manager**	31 March 2015 and implementation beyond

Pensions Audit Sub Committee

2.30 p.m., Tuesday, 16 December 2014

Lothian Pension Fund – Internal Audit Update 2014/15

Item number	5.3
Report number	
Executive/routine	
Wards	All

Executive summary

The purpose of this report is to provide a summary of Internal Audit Activity during the period 1 April 2014 to 30 November 2014.

The activity planned for the financial year 2014/15 was based on the allocation of internal audit resource across the City of Edinburgh Council's (CEC) services and was approved by the CEC's Governance and Best Value Committee on 2 April 2014.

Three internal audit reviews are planned for the 2014/15 year:

- A review of the new payment system (Immediate Payments to Pensioners);
- A review of compliance with the Scheme of Delegation; and
- A review pension administration and record keeping

The review of Immediate Payments to Pensioners has been scheduled for the new calendar year by which time it will have been implemented. The other two reviews have been completed and the matters arising are considered in this report.

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	

Report

Lothian Pension Fund – Internal Audit Update 2014/15

Recommendations

1.1 Committee is requested to:

- Note the Internal Audit activity during the period 1 April to 30 November 2014
- Note the matters arising from the two Internal Audit reviews undertaken in this period.

Background

Internal Audit plan 2014/15

2.1 The internal audit plan for the Lothian Pension Fund (LPF) was set out in the Internal Audit report to Pensions Audit Sub-Committee on 16 June 2014

2.2 The internal Audit plan is risk based, with a focus on governance, risk and controls. The areas identified for inclusion in the plan are determined following discussions with LPF management and examination of risk registers.

2.3 The plan for 2014/15 included three planned Internal Audit reviews:

- A review of the new payment system (Immediate Payments to Pensioners);
- A review of compliance with the Scheme of Delegation; and
- A review pension administration.

2.4 The review of Immediate Payments to Pensioners has been scheduled for the new calendar year by which time it will have been implemented. The other two reviews have been completed with reports and recommendations issued.

Main report

Review of compliance with the Scheme of Delegation

3.1 In order to assess the procedures & controls in place surrounding the Scheme of Delegation, Internal Audit conducted the following:

- Ascertained the existence of a Scheme of Delegation for the authorisation of investments and payments to scheme members and third parties;
- Considered whether the Scheme of Delegation complies with Local Government Pension Scheme regulations and guidance from Scottish Ministers;
- Ensured on a sample basis that Investments and Payments are being approved in accordance with the Scheme of Delegation; and
- Reviewed on a sample basis the records in place to ensure that adequate records are maintained to demonstrate compliance with the Scheme of Delegation.

3.2 As part of our procedures we reviewed a sample of 25 purchases and sales of investments selected on a hap-hazard basis.

3.3 This review identified one finding, graded medium, in connection with the authorisation of batch transactions (where an individual transaction is implemented in smaller tranches). The Custodian's Portal (Trade Capture) does not enforce authorisation of funds transfers for batch transactions.

3.4 Management sought to address this gap in the automated controls within Trade Capture. Management requested that the Custodian upgrade Trade Capture to provide the functionality needed to ensure that all batch transactions require authorisation. This upgrade has now been implemented and all future batch transactions will require authorisation on Trade Capture in line with the Scheme of Delegation.

Review of pension administration

3.5 In order to assess the procedures & controls in place surrounding pension administration, Internal Audit conducted the following:

- Reviewed the controls surrounding the record keeping of member data including key personal details, employment dates, salary details and type of scheme membership;
- Considered the controls ensuring payments to members are accurate and reflect entitlement; and
- Reviewed the controls in place surrounding the data received from member employers, which allow calculation of liabilities, contributions and payments.

3.6 As part of our procedures, we reviewed a sample of 25 joiners, leavers, retirees and deaths selected on a haphazard basis.

3.7 The review identified two findings, both graded as medium. The first was in connection with contribution reconciliations from scheme employers and the second in connection with superuser access to the LPF's IT Operating system Altair.

Contribution reconciliations

3.8 The LPF has recently commenced monthly reconciliations of contributions paid by employers to data held by the LPF. This allows the LPF to check the accuracy of their data and identify any changes not communicated to LPF by an employer. This is a key part of the LPF's procedures to ensure that the LPF will be able to meet the revised regulatory data quality standards due to come into force in 2015.

3.9 The LPF has successfully transitioned 61 of their 101 employers to providing a monthly data set that allows this reconciliation process to occur. This transition process remains ongoing but of the scheme's 4 largest employers (City of Edinburgh Council, East Lothian Council, Midlothian Council & West Lothian Council), only Midlothian Council is close to successfully completing the transition process.

3.10 If the LPF cannot fully transition their employers to a monthly process, there is a risk that they may not be able to meet the forthcoming data standards. Management recognise this risk and are continuing to encourage and assist the remaining employers to transition, but ultimately this process cannot be fully within their control and will require the co-operation of the employers. The LPF is also looking at varying the administration fee structure, in order to incentivise employers to complete the transition.

Superuser access

3.11 Four individual users have superuser access to Altair. The nature of superuser access is such that these individuals have the ability to circumvent automated controls and divert funds. The activity of these users was not being monitored by the LPF. While no indication of any inappropriate activity by superusers was identified during our procedures, we would expect their activities to be monitored.

3.12 Management have moved to address this gap in the controls and have commenced the monthly monitoring of superuser activity by the Pensions and Accounting Manager.

Measures of success

4.1 Alignment of Internal Audit activity to the key risks faced by the LPF to ensure that governance is improved, managers take responsibility for corrective action and confidence in the management of risk is increased.

Financial impact

5.1 There are no direct financial implications.

Risk, policy, compliance and governance impact

6.1 There are no adverse impacts arising from this report.

Equalities impact

7.1 There are no adverse equalities impacts arising from this report.

Sustainability impact

8.1 There are no adverse sustainability impacts arising from this report.

Consultation and engagement

9.1 None.

Background reading / external references

Internal Audit reports, 'Scheme of Delegation' and 'Pensions Administration' issued in November 2014.

Alastair Maclean

Director of Corporate Governance

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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.
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Pensions Audit Sub Committee

2.30pm, Tuesday, 16 December 2014

EU Tax Claims

Item number	5.4
Report number	
Executive/routine	
Wards	All

Executive summary

This report summarises activity on EU tax claims made on behalf of the Lothian Pension Fund. During the period since the last report, the amount of settled claims has increased by £207.2k to a total of £1,262.1k. Progress continues on the various outstanding claims.

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	

Report

EU Tax Claims

Recommendations

1.1 Committee is requested to:

- Note the progress made in reclaiming EU taxes suffered on dividends.
- Highlight any points that it would like to raise at the Pensions Committee on 17 December 2014.

Background

2.1 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.

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

Main report

Claims for EU Tax Credits – Manninen

3.1 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.

3.2 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.

3.3 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.

3.4 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.

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

3.6 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.
December 2013	Court of Appeal rejects our appeal on one specific time limit argument (based on the domestic law). A further hearing by the Court of Appeal has been set for February 2015 to consider HMRC's appeal on the substantive issues and our time limit arguments (based on European law). It is possible that the Court of Appeal will refer certain issues to the CJEU at this hearing.

3.7 Fees incurred to date, by Lothian Pension Fund, on these claims amount to £54.5k (£49.5k as at the last update to Committee in December 2013). 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

3.8 These claims are against the tax authorities of the EU member states (and Norway) in which the Fund has 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.

3.9 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. Legal action started in the Court of Appeal of Montreuil in 2013. Further legal arguments are due to be filed with the Court during the last quarter of 2014. KPMG are still positive about the ultimate payment of the claims but there is still uncertainty as to when.

Country	Claim Period From / To	Estimated Amount Claimed £'000	Amount Received £'000	Notes
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. With the continuing lack of clarity from the German tax authorities, KPMG are in the final stages of filing a complaint in the German Courts.
Italy	2004 2010	508.7	-	There have been few recent developments for pension funds in Italy. Furthermore, some Italian Court decisions announced recently have even shown reluctance on the part of the Italian Courts to recognise EU law jurisprudence over Italian law. It seems that litigation will be required in order to progress with claims in this territory. There are fewer claimants in Italy to fund litigation. KPMG feel that it is better to focus on France and Germany before considering to Italy.
Spain	2004 2009	661.4	466.1	The principle of paying the refunds was approved by the Spanish Courts in May 2013. By November 2013 we had received refunds for periods up to the first quarter of 2004. In May and July of 2014 we received refunds for quarters two to four of 2006, quarter four of 2008 and all four quarters of 2009. An additional £207.2k compared to the Committee report of December 2013. Quarter three of 2007 to quarter three of 2008 remain outstanding.
TOTAL		**3,535.7**	**1,262.1**	

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

3.11 Fees incurred to date on these claims amount to £367.7k (£351.7k as at the meeting of December 2013). 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

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

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

3.14 Claims in respect of manufactured dividends totalling £3.9m on behalf of Lothian Pension Fund has been lodged with HMRC.

3.15 KPMG has appointed a firm of solicitors (Pinsent Masons) to pursue recovery. An initial hearing of the First-tier Tribunal (FTT) took place in March 2013.

3.16 Due to continuing inaction, other than issuance of information requests from HMRC, Pinsent Masons made an application for the test case to proceed and the FTT granted this request. It is likely that the hearing will take place during the first quarter of 2015. Pinsent Masons have been in correspondence with HMRC through the course of 2014 and have now agreed a statement of facts in order to minimise the fact-finding undertaken by the Tax Tribunal at the hearing itself.

3.17 Fees incurred to date on these claims amount to £100.4k (£92.0k as at the meeting of December 2013). Potential subsequent referrals are estimated to cost £20k for each legal stage.

Measures of success

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

Financial impact

5.1 EU tax claims totalling in excess of £10m have now been lodged with the relevant tax authorities. Professional fees amounting to £522.6k 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.

5.2 Currently, claims paid to date exceed the costs incurred by £739.5k. 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	54.5
Fokus Bank	3,535.7	1,262.1	2,273.6	367.7
Manufactured Dividends	3,928.6	Nil	3,928.6	100.4
	10,091.0	**1,262.1**	**8,828.9**	**522.6**

Risk, policy, compliance and governance impact

6.1 There are no risk, policy, compliance and governance impacts arising from this report.

Equalities impact

7.1 There are no equalities impacts arising from this report.

Sustainability impact

8.1 There are no sustainability impacts arising from this report.

Consultation and engagement

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

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.
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Pensions Audit Sub Committee

2.30pm, Tuesday, 16 December 2014

Global Custody Services performance

Item number	5.5
Report number	
Executive/routine	
Wards	All

Executive summary

This report presents the Key Performance Indicator Report for the 12 months ended 30 September 2014 provided by the Fund's custodian, 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 currently meeting the needs of the three Pension Funds and are of a high standard.

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	

Report

Global Custody Services Performance

Recommendations

1.1 Committee is requested to:

- Note the contents of this report

Background

2.1 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.

2.2 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 12 months ended 30 September 2014. The indicators cover the services listed above.

2.3 In addition, Northern Trust provides foreign exchange conversion and investment income tax services. The performance of these services is assessed in separate reports that are presented to Committee on an annual basis. The only other significant service provided is securities lending, this revenue item being included in the budget and outturn figures which are also presented to Committee.

Main report

3.1 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 Over 12 Months to 30/9/14	Green (Previous Report: Green) Work completed by business day 14 for all months in period.
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 12 Months to 30/9/14	Green (Previous Report: Green) Work completed by business day 18 for all months in period.
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 cash 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 12 Months to 30/9/14	Green (Previous Report: Green 96.69%) 97.19%
Comments	During the period there were a total of 11,125 trades of which 10,812 (97.19%) were settled on time. Of the 313 trades settled late, 228 were purchases and 85 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; 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 12 Months to 30/9/14	Green (Previous Report: Green 98.16%) 98.35%
Comments	The performance indicator is based on the number of income collections rather than their value. During the period there were a total of 2,965 income collections, 2,916 (98.35%) of which were received on the correct pay day. Northern Trust provides a range of reports on income receipts 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 around 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. Responses are made by external and internal investment managers for the portfolios that they are responsible for.
Performance Traffic Lights	Green – 100% Amber – 95% to 99% Red – 94% or lower
Service Rating Over 12 Months to 30/9/14	Amber 95.50% (Previous Report: Amber 95.13%)
Comments	During the period there were 444 corporate actions, 424 (95.50%) 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. The twenty late items have been reviewed to assess the

	potential consequences. Virtually, all relate to the option to elect to take additional shares instead of a cash dividend. The assessment is that these and the other late items do not represent the potential for financial loss. We are looking at the possibility of a more proactive monthly monitoring of late events.

Measures of success

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

Financial impact

5.1 The budget set for the provision of custody services for 2014/15 is £282k. This report has no impact on the cost of custody provision.

5.2 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.

5.3 The cost and quality of custody services are assessed as part of a rigorous competitive procurement exercise. Northern Trust was the clear winner of the last procurement. The contact is for five years ending in February 2017, with the option to extend for a further three years.

Risk, policy, compliance and governance impact

6.1 There are no risk, policy, compliance and governance impacts arising from this report.

Equalities impact

7.1 There are no equalities impacts arising from this report.

Sustainability impact

8.1 There are no sustainability impacts arising from this report.

Consultation and engagement

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

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	None

Pensions Audit Sub Committee

2.30pm, Tuesday, 16 December 2014

Investment Income Review – Cross Border Withholding Tax

Item number	5.6
Report number	
Executive/routine	
Wards	All

Executive summary

This report provides information on a benchmarking study prepared by KPMG into the effectiveness of the procedures in place to manage the tax exposure on the investment income of Lothian Pension Fund and Lothian Buses Pension Fund.

The benchmarking report prepared by KPMG shows that Northern Trust is generally applying the correct withholding tax rates on investment income and that recovery claims are generally processed within satisfactory timescales However, two important issues have been identified that need further investigation:

1. Subject to further investigation; it may be possible to recover around £362k of tax suffered on US dividends.
2. Swiss claims, around 80% of the total claims outstanding for Lothian Pension Fund, are taking over 2 years to recover, in comparison to KPMG's expectation of 12 months.

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	

Report

Investment Income Review – Cross Border Withholding Tax

Recommendations

1.1 Committee is requested to:

- Note the contents of the report;

Background

The Taxation Environment

2.1 Lothian Pension Fund (LPF) and Lothian Buses Pension Fund (LBPF) invest directly in stock markets across the globe. These investments generate income that is potentially liable to income tax in the country of tax domicile. During the 2013/14 financial year the Pension Funds earned income from companies in 47 different countries.

2.2 UK pension funds are usually able to benefit from beneficial tax rates. These rates are normally determined by separate tax treaties established between the UK Government and most foreign countries. Tax on dividends varies between 0% and 35%. In contrast, income on fixed interest stocks is usually free from tax.

2.3 In virtually all countries income is subject to taxation at source, so the owner of the investments receives the income net of the appropriate amount of tax. Taxation deducted in this way is called withholding tax or WHT for short.

2.4 In some countries the preferential rate for UK pension funds is subject to providing the tax authorities of the country concerned with an application and supporting paperwork. The exact requirements vary from country to country and in some cases can be quite onerous. Failure to have preferential rate approval in place means that income will be subject to a higher rate of tax than is necessary.

2.5 The preferential rate may be applied at source, meaning that there is no tax to reclaim from the foreign tax authority. Alternatively, the rules of the country may require tax to be deducted at the full rate with a subsequent claim having to be made to the tax authority to get repayment of the difference between the full rate and the preferential rate.

2.6 The requirements to make a valid repayment claim and the time it takes for the claim to be paid vary considerably from country to country.

2.7 With the exception of India, realised investment gains are generally not subject to UK or overseas capital gains tax.

The Role of the Custodian

2.8 The custodian appointed for the three pension funds is Northern Trust (NT). The Scottish Homes Pension Fund is invested in pooled funds, so there is no requirement to recover income tax as this is organised by the pooled fund manager.

2.9 In addition to the vital roles of holding title to investments on behalf of the investor, the global investment custodian is responsible for the management of the procedures and processes that relate to the taxation of investment income.

The Scale of Activity

2.10 The tables below show the movement in the reclaimable tax balances during the 2013/14 and 2012/13 financial years for both Lothian Pension Fund and Lothian Buses Pension Fund. Also included in the table is the amount of tax suffered by each fund that is not recoverable.

Lothian Pension Fund	**2013/14** **£**		**2012/13** **£**
Brought Forward 1 April	1,842,564.05		1,431,621.30
Recoverable tax accrued during year	1,751,330.62		814,393.53
Claims paid during year	(1,062,852.44)		(403,450.78)
Carried Forward 31 March	2,531,042.23		1,842,564.05
Irrecoverable Tax Deducted	2,001,907.34		1,965,527.37

Lothian Buses Pension Fund	**2013/14** **£**		**2012/13** **£**
Brought Forward 1 April	286,235.33		179,179.25
Recoverable tax accrued during year	168,919.59		112,175.17
Claims paid during year	(134,895.62)		(5,119.09)
Carried Forward 31 March	320,259.30		286,235.33
Irrecoverable Tax Deducted	98,054.54		70,543.81

2.11 In the case of both funds there have been considerable increases in both the amount of recoverable tax accruing during the year and the claims received. The amount of recoverable tax accruing is a function of a number of factors, including the level of investment income and the tax policies of the countries in which the dividends were earned.

2.12 The year end recoverable tax balances at 31 March 2013 and 31 March 2014, broken-down by country for both Lothian Pension Fund and Lothian Buses Pension Fund are provided in the tables below.

Lothian Pension Fund	Reclaim Amount 31/3/14 £	Number of Dividends 31/3/14		Reclaim Amount 31/3/13 £	Number of Dividends 31/3/13
Austria	23,663.09	31		8,588.53	14
Belgium	41,106.58	5		76,929.38	6
Canada	15,117.68	7		-	-
Denmark	979.88	1		8,587.24	8
France	3,196.29	3		57.19	1
Germany	11,958.49	4		79,234.52	86
Ireland	-	-		1,440.28	1
Japan	24,188.83	10		40,872.39	13
Jersey, Channel Islands	-	-		212.64	1
Netherlands	34,911.14	6		17,331.36	5
Norway	115,841.23	10		87,019.34	17
Poland	10,934.80	1		11,152.77	1
South Africa	-	-		13,952.69	9
Spain	-	-		36,244.42	58
Switzerland	2,100,482.41	61		1,419,422.68	48
United Kingdom	146,100.43	14		41,518.62	4
United States	2,561.38	3			
Grand Total	**2,531,042.23**	**156**		**1,842,564.05**	**272**

Lothian Buses Pension Fund	Reclaim Amount 31/3/14 £	Number of Dividends 31/3/14		Reclaim Amount 31/3/13 £	Number of Dividends 31/3/13
Canada	783.78	4		-	-
Denmark	243.32	1			
Germany	3,194.38	2		-	-
Japan	499.52	1		600.74	1
Netherlands	419.08	1		-	-
Norway	7,025.68	4		8,942.53	3
South Africa				2,278.21	2
Switzerland	307,589.08	12		265,639.60	9
United Kingdom	504.56	1		8,774.25	1
Grand Total	**320,259.30**	**26**		**286,236.33**	**16**

2.13 For Lothian Pension Fund, Switzerland accounts for 83% (77% at 31 March 2013) for the total amount receivable and for Lothian Buses Pension Fund the percentage for Switzerland is 96% (93% at 31 March 2013). The reason why the Swiss total claim value is so large is that 35% tax is deducted on all dividends and the 0% rate relief is obtained by claiming the tax paid back. There are few other countries where the tax deducted at source is so high.

2.14 The tables below demonstrate that despite the rise in recoverable tax balances the relative age of the amounts due is not deteriorating.

Lothian Pension Fund	**Reclaim Amount 31/3/14 £**	**Reclaim Amount 31/3/14 %**		**Reclaim Amount 31/3/13 £**	**Reclaim Amount 31/3/13 %**
Within 1 Year	1,360,494.57	54		973,775.90	53
1 to 2 Years	698,389.41	28		566,302.53	31
2 to 3 Years	331,383.13	13		210,070.35	11
Older than 3 Years	140,775.12	5		92,415.27	5
Grand Total	2,531,042.23	100		1,842,564.05	100

Lothian Buses Pension Fund	**Reclaim Amount 31/3/14 £**	**Reclaim Amount 31/3/14 %**		**Reclaim Amount 31/3/13 £**	**Reclaim Amount 31/3/13 %**
Within 1 Year	163,074.61	51		125,608.59	44
1 to 2 Years	101,105.73	32		108,156.97	38
2 to 3 Years	56,033.96	17		52,569.77	18
Older than 3 Years	-	-		--	-
Grand Total	320,259.30	100		286,235.33	100

Main report

Benchmarking Study

3.1 Given the complexity and scale of the taxation of investment income, it is important that Northern Trust (NT) provides an efficient service. Failure to ensure that the correct tax rates are being applied would result in a direct loss of income. Poor management of the tax reclaim process could mean that recoverable tax is never recovered or unnecessarily delayed.

3.2 In order to assess the effectiveness of NT's work, KPMG has been commissioned to prepare a benchmarking report. KPMG's remit was:

- Review the most recent withholding tax table produced by NT and verify the withholding tax rates that have been applied to income received from a number of source countries;
- Identify areas where there is opportunity for greater relief from withholding tax than that currently being applied;
- Quantify the amount of withholding tax that could potentially be reclaimed for the chosen study period (12 months to 31 August 2014);
- Review the withholding tax reclaims that have already been processed by NT and assess their timeliness.

Findings – WHT Rates

3.3 The study concluded that generally NT has been applying the appropriate withholding tax rates for a UK pension fund. However, they have identified a small number of opportunities and issues.

3.4 The most significant opportunity identified is 21 dividends from US investments that have suffered WHT at 35%. The entitled rate in the US is 0%, subject to further investigation; it may be possible to recover around £362k.

3.5 The main issues and the actions taken are summarised in the Appendix to this report. At the time of preparing this report we are awaiting responses from NT, a verbal update will be provided at the meeting.

Findings – WHT Claims

3.6 The reclaim process consists of the custodian preparing an application in the required format for the country concerned. Once the application has been lodged with the tax authorities of the country, it will take the authority an amount to time to process the claim and pay the refund to. This processing time varies from country to country – some take a matter of months and others will take a number of years.

3.7 The KPMG report identified a number of examples of delays in refunds being made, but with the exception of the Swiss claims the amounts involved were relatively low.

3.8 As at 31 March 2014, Swiss claims accounted for 83% of the total claims outstanding for Lothian Pension Fund. Last year's report to Committee highlighted Swiss claims were taking more that two years compared to an expectation of one year. As a result of discussions with NT it was reported that procedures had been tightened to reduce the time claims were taking to process. Unfortunately, this year's report indicates that there has apparently been no improvement. As at 31 October 2014, the claims for the calendar year 2012 amounting to £541k remain outstanding. An explanation is being sought from NT and a verbal report will be given at the meeting.

3.9 The other issues and the actions taken are summarised in the Appendix to this report. At the time of preparing this report we are awaiting responses from NT, a verbal update will be provided at the meeting.

Measures of success

4.1 Minimising exposure to tax on investment income.

4.2 Obtaining prompt recovery of reclaimable income tax deducted at source.

Financial impact

5.1 The recoverable tax accrued during 2013/14 on Lothian Pension Fund was £1,751k (£814k 2012/13); claims paid were £1,063k (£403k 2012/13), leaving a balance to be recovered of £2,531 at 31 March 2014 (£1,843k at 31 March 2013). For Lothian Buses Pension Fund, recoverable tax accrued during 2013/14 was £169k (£112k 2012/13); claims paid were £135k (£5k 2012/13), with the balance of £320k at 31 March 2014 (£286k at 31 March 2013).

5.2 The KPMG report contains a suggestion to potentially recover an £362k in tax on US dividends and apparent delays in recovering tax on Swiss dividends are being investigated.

Risk, policy, compliance and governance impact

6.1 There are no risk, policy, compliance and governance impacts arising from this report.

Equalities impact

7.1 There are no adverse equalities impacts arising from this report.

Sustainability impact

8.1 There are no adverse sustainability impacts arising from this report.

Consultation and engagement

9.1 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	Summary of the findings of the withholding tax benchmarking report

Appendix - Summary of the findings of the withholding tax benchmarking report

Country	Findings	Conclusions as at Date of Report to Pensions Audit Sub-Committee
Australia WHT Rate	“Franked” dividends are exempt from WHT in Australia. Under Australian domestic legislation LPF should also be entitled to a 0% rate of WHT on “unfranked” dividends received from Australia, if they have obtained a ruling from the Australian Tax Authorities showing that they are comparable to an Australian superannuation fund. It is unclear whether this clearance has been obtained as 30 dividends have been subjected to WHT at rates from 8.79% to 30%. LPF could be entitled to refunds of these amounts if the necessary clearance has been obtained. The total tax leakage across these dividends is AU$63,547 (£ 34,603).	KPMG raised the question of the ruling in their previous report. We contacted NT and established that a ruling had been agreed with the Australian tax authorities for the period 1 July 2012 to 30 June 2015. In most cases the 0% ruling has been applied. Therefore, the non-application of the ruling to what appears to be a random selection of dividends has been raised with NT.
Belgium WHT Claims	Belgian Reclaims should be refunded within 36 months. 4 Tax reclaims have been outstanding for more than 89 months. Whilst we note that their current status is “Prior Custodian Accrual” it is important that these reclaims have been submitted within the 5 year statute of limitations.	Investigation has shown that the 4 old claims referred to were recovered by the prior custodian and sent to NT in January 2014. We have contacted NT to ensure that the funds are traced and the debtors cleared. The amount involved is €59,288.50.
Canada WHT Rate	Generally, dividends received from Canada suffer a WHT rate of WHT of 15%. 2 dividends from the National Bank of Canada have suffered 25% WHT. The over-withholding totals CD$ 7,227 (£4,020).	Awaiting comments from NT.
Dominican Republic WHT Rate	A rate of 10% applies to Dominican Republic government bonds. There are 3 Dominican Republic 5.875% 18/04/24 which have been paid gross. The potential under withholding totals US$ 5,630 (£3,548) however, these may be manufactured payments.	Confirmed that the payment was not manufactured. Awaiting comments from NT.
Indonesia (Dividends) WHT Rate	A 15% dividend WHT is available to LPF; however 4 dividends (Gudang Garam TBK, PT Media Nusantara and 2 x Unilever Indonesia) have been paid at a rate of 20%. The total tax leakage on these dividends is IDR 54,819,250. (£2,840).	Awaiting comments from NT.
Indonesia (Interest) WHT Rate	A 10% interest WHT is available to LPF; however 7 corporate bond payments in Pertamina have been paid gross. The potential under-withholding is US$10,120 (£6,380). These bonds have US ISIN numbers and may have been treated as US source income.	Awaiting comments from NT.

Japan WHT Rate	A 0% rate is available to LPF, however 1 dividend (NTT Docomo – Due 20 June 2014) has been taxed at 15.31% (£4,453.41). It is not clear why this has occurred and whilst we are aware that a refund of the WHT was paid at a later date we recommend that you raise this with your custodian.	Awaiting comments from NT.
Japan WHT Claims	8 Japanese reclaims have been submitted to the sub-custodian. Reclaims should not be necessary as relief at source is available.	Awaiting comments from NT.
Kazakhstan WHT Rate	The domestic WHT rate in Kazakhstan is 15%, however the Kazmunaigas Exploration dividend paid on 1 July 2014 was taxed at 20%. There is currently no process for relief at source or reclaims in Kazakhstan, so we suggest you raise this with your custodian. The potential tax leakage is US$ 11,086 (£6,975).	Awaiting comments from NT.
Netherlands WHT Claims	Netherlands reclaims should be refunded within 12 months. 2 reclaims have been outstanding for 17 months and 1 reclaim has been outstanding for 42 months.	Awaiting comments from NT.
Philippines WHT Rate	The standard rate of WHT of 30% has been applied to all dividends received from the Philippines. A reduced rate of 25% should be available to LPF under the Philippines/UK Treaty. The tax leakage identified is approximately US$12,904 (£8,114). We recommend that you raise this with your custodian, however as these amounts relate to ADRs it may be extremely difficult to recover this tax.	Awaiting comments from NT. Awaiting comments from NT.
Poland WHT Claims	Polish reclaims should be refunded within 12 months. 1 reclaim has been outstanding for 40 months, and currently has the status "Certification requested".	Value is around £11k.
Russia WHT Rate	LPF has received most dividends at the correct WHT rate of 15%, however 5 were paid at 10%. This is the rate under the Russia/UK Treaty, however, as the Treaty contains a subject to tax clause LPF should not be entitled to this rate. The under-withholding totals US$ 28,102 (£17,709).	Awaiting comments from NT.
Switzerland WHT Claims	Numerous Swiss reclaims have been outstanding for longer than the expected timeframe. We are aware that Switzerland only allows 1 claim per year, and that some custodians have faced issues in this market previously. However the majority of these claims should now have been submitted by the custodian and the ability to consolidate different years onto one reclaim form should reduce the amount of time the refund should take.	KPMG expect Swiss claims to take 12 months to recover. It is evident that NT claims are taking more than twice that amount of time. However, the NT report indicates that they regard only one dividend to be outside their normal claim parameter for Switzerland. Given the value of the claims we are pressing NT for an early response. Awaiting comments from NT.

Taiwan WHT Rate	Dividends received from Taiwan are suffering WHT at a rate of 20%. Under the Taiwan/UK tax treaty a reduced rate of 10% should be available to LPF. The potential tax leakage is TWD 4,742,400 (£97,527). We understand that you are aware of this and are making reclaims separately.	Confirmed that a claims procedure is in place.
USA WHT Rate	LPF is entitled to a 0% WHT rate on dividends in the United States. 21 dividends have suffered a 35% WHT. The tax leakage identified is approximately US$ 576,305 (£362,319). These payments relate to US listed partnerships therefore a reclaim should be available.	Awaiting comments from NT.
USA WHT Claim	1 United States reclaim has been outstanding for 35 months. The stock is actually Irish and therefore we would normally expect relief at source to have been applied, or alternatively repayment within 6 months.	There are 3 US claims outstanding with a total value of £2.5k.

Pensions Audit Sub Committee

2.30 p.m., Tuesday, 16 December 2014

Class Actions

Item number	5.7
Report number	
Executive/routine	
Wards	All

Executive summary

This report provides an annual update on the Funds' class action activity. A class action is where a group (a class) sues another party. Typically, these actions happen in the US. The type of class action relevant to the Funds is when a group of shareholders collectively sue a company in order to recover a loss in share value, or to exert influence on the company. Since 2006 the fund has received US$3.0 million in class action compensation. US$139k has been received since the last update to Committee in December 2013.

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	

Report

Class Actions

Recommendations

1.1 Committee is requested to:

- note the update on class actions; and
- highlight any points that it would like to raise at the Pensions Committee on 17 December 2014.

Background

2.1 In shareholder class actions one or more investors agree to act as lead plaintiff(s). A law firm acts 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. In the United States, cases are typically taken on a no win, no fee basis.

2.2 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.

2.3 In addition, the Lothian Pension Fund may act 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.

2.4 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.

Main report

Compensation

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

Financial Year	US$ (000's)
Prior to 31/03/11	1,823
2011/12	317
2012/13	483
2013/14	287
2014/15 **[1]**	59
TOTAL [1]	**2,969**
[1] To 31 October 2014	

3.2 The last Committee report in December 2013 contained figures to 31 October 2013. In the remainder of that financial year a further $80k was received. There have been 11 settlements so far this financial year, with a total value of $59k. Included in this figure are two payments from Citigroup totalling $37k.

Lead Plaintiff Cases

3.3 All cases where the Fund was acting as lead plaintiff have now concluded. Summaries of the most recent cases are included Appendix 1. Compensation has been received from one of these cases but was minimal, $4.7k.

Impact of the Morrison ruling

3.4 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.

3.5 Officers have reviewed a small number of such cases. Considerations have included the estimated financial loss, potential for recovery, the resource needed to monitor the case and the risk of further detriment to the Fund.

3.6 Lothian Pension Fund will consider the potential benefits and risks on a case by case basis.

Measures of success

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

Financial impact

5.1 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 $3.0m in compensation from class actions.

Risk, policy, compliance and governance impact

6.1 The class action activity detailed in this report is undertaken as part of the Environmental Social and Governance (ESG) activity of the Fund which is expected to reduce risk. Class action activity is contributes to Fund stewardship and governance responsibilities.

Equalities impact

7.1 There are no adverse equalities impacts arising from this report.

Sustainability impact

8.1 Class action activity is undertaken as part of the ESG activity of the Fund which is expected to contribute to the sustainability of the Fund's investments.

Consultation and engagement

9.1 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

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	Appendix 1 – Class Actions

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

- The case against **Lehman Brothers** was in relation to false financial statements and mismanagement at the company prior to the collapse of the bank. The case consisted of separate claims against certain officers, the directors, underwriters and auditors. The case was filed in 2008 and the estimated loss to the Fund was $4.7m. Shares were purchased in the US. In August 2011, the case against the company officers and directors agreed to a settlement of $90m and the case against the Underwriters settled for $426m. In May 2012 the court gave final approval to the $90m settlement with Lehman directors and officers and $426m with the underwriters. Subsequently, the case against Lehman's accountants Ernst & Young (E&Y) settled for $90m. Although Lothian was lead plaintiff in the overall case it was not named as a class representative for the E&Y case because of the court's ruling severely limiting the class period against E&Y. Whilst the settlements achieved are sizeable in monetary terms, they are a relatively small proportion of the overall shareholders' losses. This, together with the fact that the Fund's trading in stock (and not any of the offering underwritten by the Underwriters) meant that it qualified for recovery in only the claim against the directors and officers. This resulted in a recovery for the Fund of $4.7k, which was received in December 2013.

- The Fund had an estimated loss of $2.0m due to holdings in the company **Wyeth**. The case was 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. In June 2014 the court decided against the appeal. This was not unexpected as misrepresentation is difficult to prove. The case is now closed.

- 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 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. In June 2014 the Court of Appeal denied the appeal against dismissal and denied leave to amend the complaint. The case is now closed.

Pensions Audit Sub Committee

2.30pm, Tuesday, 16 December 2014

Risk Management

Item number	5.8
Report number	
Executive/routine	
Wards	All

Executive summary

The pension funds' 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 November 2014, is set out in the appendix to this report.

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

Risk Management

Recommendations

1.1 Committee is requested to:

- note the Quarterly Risk Overview; and
- highlight any points it wishes to raise at the Pensions Committee on 17 December 2014.

Measures of success

2.1 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.

2.2 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

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

Risk, policy, compliance and governance impact

4.1 Please see the Quarterly Risk Overview appended to this report.

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	Appendix 1 - Quarterly Risk Overview, as at November 2014

QUARTERLY RISK OVERVIEW

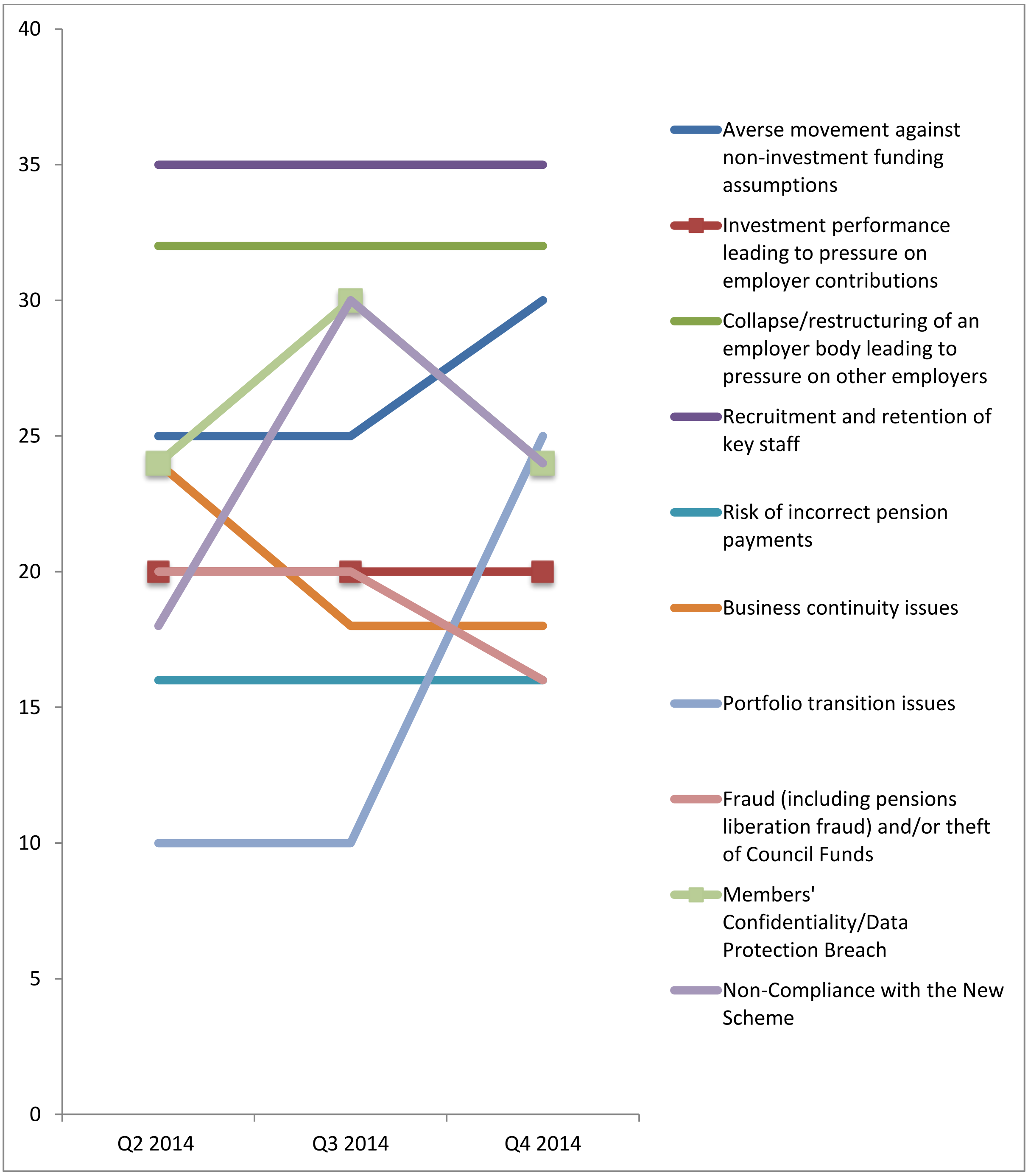
November 2014

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 to mitigate this risk and more detailed reporting on the Investment Strategy has been produced for the Pensions Committee.
Adverse movement against non-investment funding assumptions leading to pressure on employer contributions	Progress continues to be made on the 2014 actuarial valuation and experience against funding assumptions and employer contributions are being assessed as part of this process.
Collapse/restructuring of an employer body leading to pressure on other employers	We have concluded our covenant analysis and will look to prioritise the actions arising from this and implement them accordingly. The employers are being made aware of their results as part of the 2014 valuation and we will look to build on this analysis and continue to monitor employer covenant on an ongoing basis.
Recruitment and retention of key staff	This risk remains high as the agreed steps to mitigate the risk associated with the Investment function continue to be implemented and, separately, there have been a number of key departures from the Pensions Administration and Employer Relations teams. In the meantime, contingency plans have been considered for the internal investment portfolios in the event of significant staff turnover. We are also looking to recruit a newly qualified solicitor to provide appropriate cover and continuity for the Legal & Risk function in anticipation of our having to meet increased compliance requirements in advance of FCA authorisation.
Risk of incorrect pension payments	Progress to achieve full integration/automation to reduce reliance on manual intervention in some processes is ongoing and is expected to complete in Q1 2015. The risk therefore remains static for now, but once appropriate solutions are implemented and internal audit have reviewed the processes, we would anticipate this risk being further reduced to the extent that it would not be worthwhile highlighting to the Committee.
Members' Confidential Data is lost or made public / breach of Data Protection Act	We are continuing to liaise with the Council's ICT and Data Protection teams regarding our systems and processes and initial feedback has been that our systems and processes are robust and fit for purpose. This risk has been reduced to reflect the work that has been done in reviewing our systems and controls and recognising that there have been no subsequent Data Protection breaches.

Fraud (including pensions liberation fraud) and/or theft of pension fund monies	We have received several responses from Action Fraud confirming that a number of the potentially fraudulent schemes we have highlighted concerns about are now under formal investigation. We have also been provided with the details of a direct contact at Action Fraud, which will greatly assist our ability to deal with these matters more quickly and provide our members with greater certainty in transfer-out processes that are reviewed with such concerns in mind. The risk of our being approached by fraudulent schemes continues, but we have lowered the overall risk here to reflect the fact that schemes are now being prosecuted/closed-down by Action Fraud and that we are better placed to make informed decisions in relation to cases that do arise.
Adverse assumptions leading to pressure on employer contributions; Fraud.	We continue to closely monitor the levels of transfers-out to determine whether there will be an increase in light of increased flexibility in Defined Contribution (DC) pensions and the decision to allow transfers from the LGPS to Defined Contribution schemes. This could have implications for funding and cash-flow and investigations on the potential implications will be taken forward.
Breach of Contract	The initial contract review has been completed and has not identified any material concerns. However, we are in the process of refining our review and so this risk should remain static until that process has been completed. We anticipate that this risk should be significantly reduced once this review has been completed.
Business continuity	Heywood Limited has outsourced the provision of the disaster recovery services to Blue Chip Limited and we await the results of the annual disaster recovery test, due to take place in November 2014 and Heywoods confirmation of their own assessment of Blue-chips systems. This risk should therefore remain static until this information has been received.
Non-compliance with the new LGPS Scheme in Scotland / Public Service Pensions Act 2013	Benefit regulations have been finalised. Implementation of the systems required to administer the new scheme remain challenging but manageable. The timetable for producing the regulations for the governance of the new scheme is challenging. We and the other Scottish administering authorities have raised concerns around the competency of the current draft regulations regarding the governance of the new scheme and await feedback from the consultation process. Progress to implement the required changes will be made in the coming months.
Portfolio Transition	Plans are being put in place to transition two investment portfolios to further implement the new investment strategy. The risk on the register has been increased reflecting the additional workload and issues involved. Following successful implementation, the risk will be reduced.

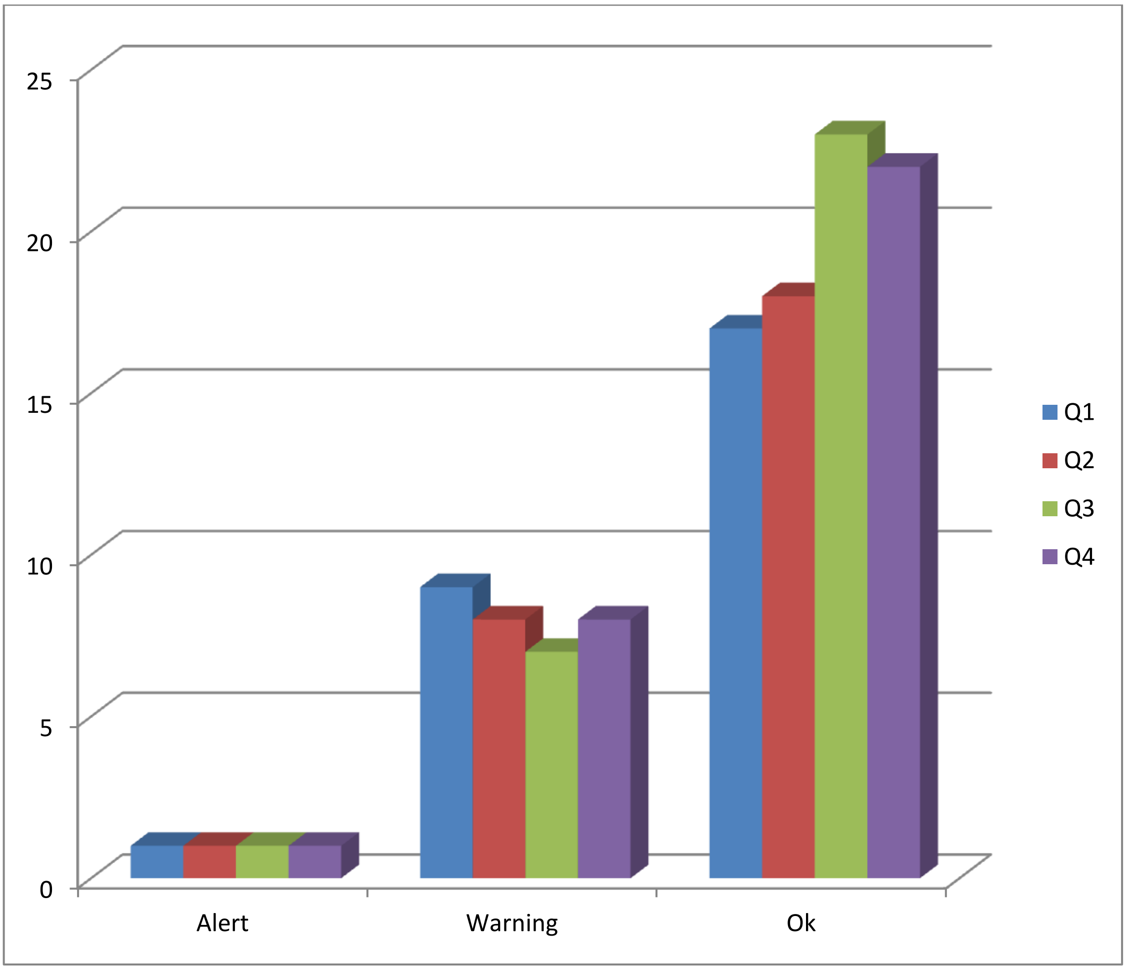
NOTABLE RISKS: PROGRESSION OF CURRENT RISK (ACCOUNTING FOR CONTROLS) IN LAST THREE QUARTERS



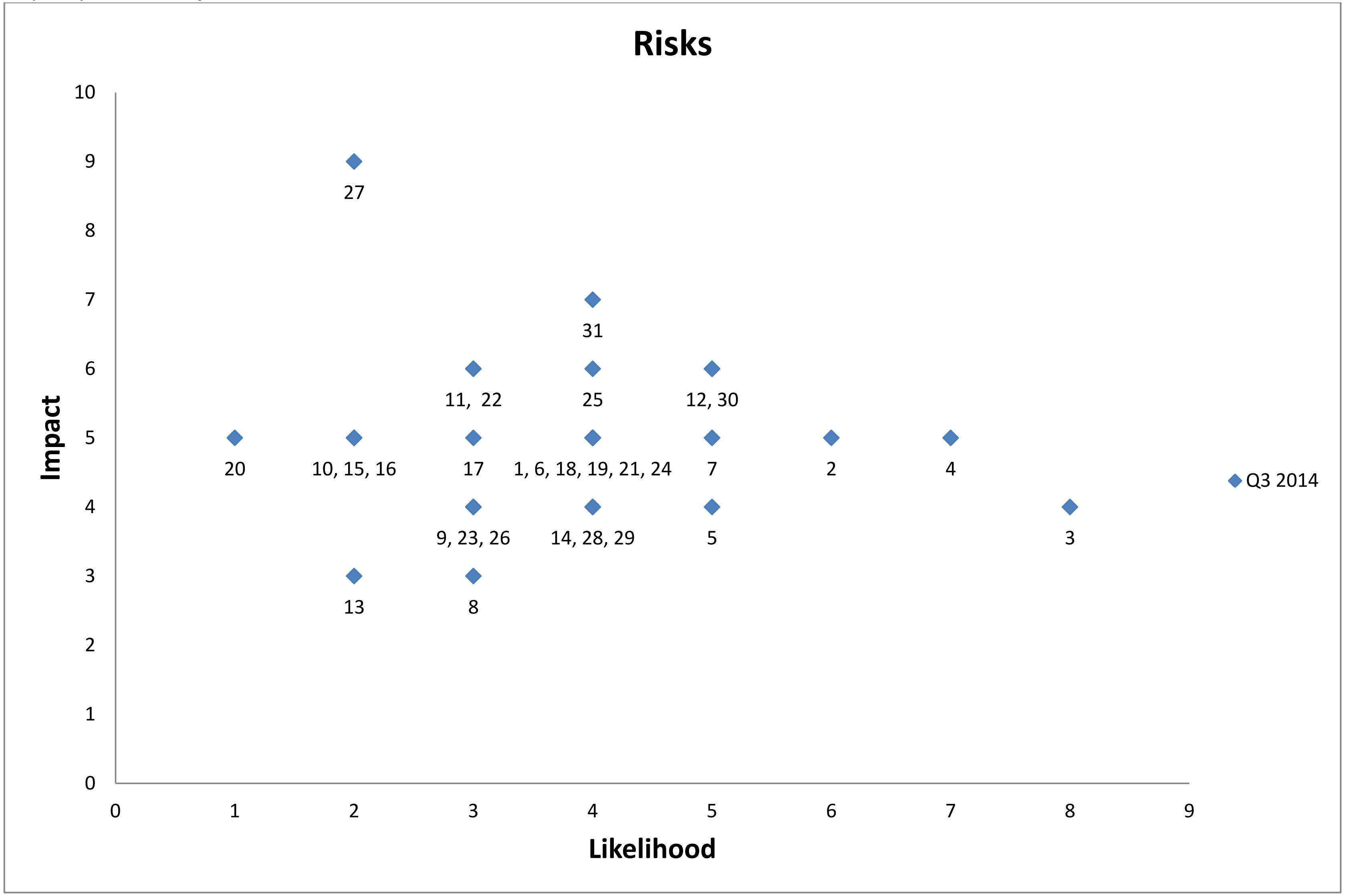
OTHER KEY POINTS

	Comments
New significant risks	None
Other new risks	We are currently monitoring the resource within the division to ensure that key project receive sufficient and dedicated time.
New controls	Additional HR resource is in place for FCA and Staffing project.
Eliminated risks	None
Notable initiatives / actions	Following Council approval on 23 October 2014, progressing continues with the establishment of a Council controlled structure for the purposes of facilitating FCA authorisation and to mitigate the identified staffing risk. The arrangement with Falkirk Council will shift from a services arrangement to a pooled secondment arrangement in December 2014 which will reduce the risk to Lothian Pension Fund, subject to Council approval. Initial outcomes of the employer covenant review are being shared with guarantors and used as part of the 2014 actuarial valuation. The National Framework for Legal Services has now been completed, providing LPF with enhanced and more streamlined access to specialist legal firms in the pensions and investment sectors.
Material Litigation	None.

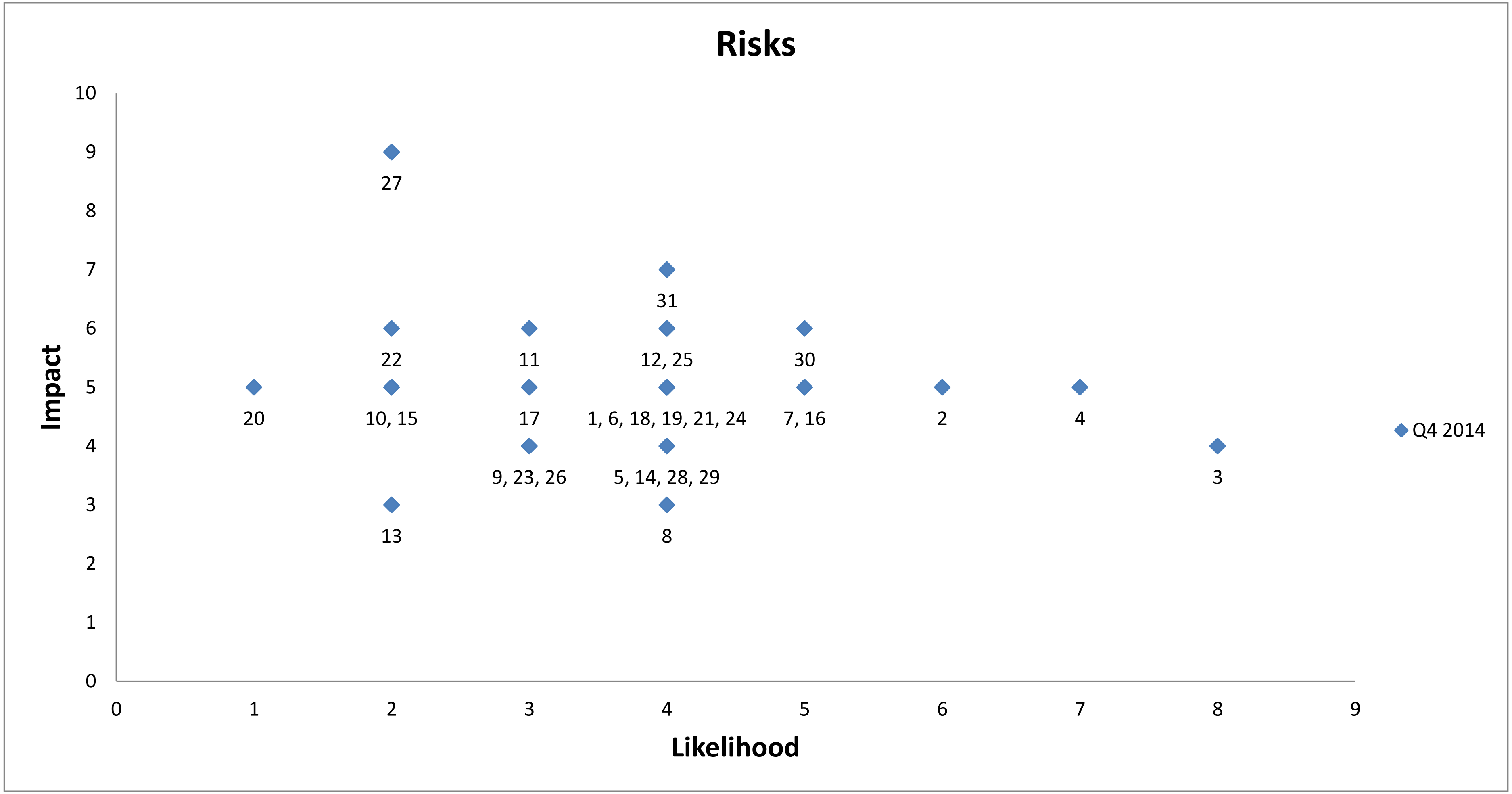
All Risks: Status Overview



Q3 (2014) All Risks: Impact and Likelihood Overview



Q4 (2014) 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	Not 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	28	Unauthorised access to PensionsWEB
29	Limited or incorrect data from Employers	30	Receiving services without adequate contractual protection
31	Over-reliance on single service provider		