Notice of meeting and agenda

Pensions Audit Sub Committee

10.00am, Tuesday 15 December 2015

Dunedin Room, City Chambers, 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 Pensions Board 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 Minutes of the meeting of 29 September 2015 – submitted for approval as a correct record (circulated)

5. Reports

5.1 Considerations and matters to be raised by the Pension Board regarding any items on the agenda

5.2 Agenda Planning – report by the Deputy Chief Executive (circulated)

5.3 Lothian Pension Fund – Internal Audit Update 2015/16 - report by the Chief Internal Auditor (circulated)

5.4 Investment Controls and Compliance - report by the Deputy Chief Executive (circulated)

5.5 EU and Other Tax Claims – report by the Chief Internal Auditor (circulated)

5.6 Global Custody Services Performance – report by the Deputy Chief Executive (circulated)

5.7 Investment Income Review Cross Border Withholding Tax – report by the Deputy Chief Executive (circulated)

6. Motions

6.1 If any

Carol Campbell

Head of Legal and Risk

Committee Members

Councillors Rose (Convener), Bill Cook and Orr.

Information about the Pensions Committee

The Pensions Audit Sub-Committee consists of 3 Councillors and its membership is appointed by the Pensions Committee.

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

Further information

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

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

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

Item 4.1 - Minutes

Pensions Audit Sub-Committee of the Pensions Committee

2.00 pm, Tuesday 29 September 2015

Present

Councillors Rose (Convener) and Orr.

Pensions Board Members Present:

Simon Belfer and Catrina Warren.

1. Minute

Decision

To approve the minute of the Pensions Audit Sub-Committee of the Pensions Committee of 23 June 2015 as a correct record.

2. Considerations and Matters to be raised by the Pension Board regarding any items on the agenda

Decision

To note that there were no issues raised under this item.

3. Agenda Planning

An overview of potential reports for future Pensions Committee and Pensions Audit Sub-Committee meetings for December 2015 and March 2016 were outlined.

Decision

To note the agenda planning document.

(Reference – report by the Deputy Chief Executive, submitted.)

4. Audited Annual Report 2015 of the Lothian Pension Fund, Lothian Buses Pension Fund and Scottish Homes Pension Fund

Audit Scotland had undertaken its statutory audit of the Annual Report 2015 of the three pension funds administered by the City of Edinburgh Council. Only minor presentational changes were made to the unaudited version.

A representative from Audit Scotland was present for this item.

Decision

To note the audited Annual Report for the year ended 31 March 2015 for the Lothian Pension Fund, the Lothian Buses Pension Fund and the Scottish Homes Pension Fund.

(Reference – report by the Deputy Chief Executive, submitted.)

5. Report by the External Auditor on the Annual Report 2015 of the Lothian Pension Fund, Lothian Buses Pension Fund and Scottish Homes Pension Fund

The External Auditor had presented their annual report on the 2014/15 audit of the Lothian Pension Fund, the Lothian Buses Pension Fund and the Scottish Homes Pension Fund.

A representative from Audit Scotland was present for this item.

Decision

1) To note the Annual Report on the 2014/15 audit of the Lothian Pension Fund, Lothian Buses Pension Fund and Scottish Homes Pension Fund.

2) To note the action plan at appendix iii of the Deputy Chief Executive's report and to seek appropriate updates on progress.

(Reference – report by the Deputy Chief Executive, submitted.)

6. Lothian Pension Fund – Internal Audit Update 2015/16

A summary was provided of the Internal Audit activity between 1 April 2015 and 31 August 2015. Three internal audit reviews ere scheduled for 2015/16.

Decision

1) To note the Internal Audit activity during the period 1 April to 31 August 2015.

2) To note the matters arising form the Internal Audit review undertaken in this period.

(Reference – report by the Chief Internal Auditor, submitted.)

7. Pension Administration Data Quality

An update was provided on the ongoing work to enhance the quality of pension administration membership record data and improve the flow of data from employers through regular reporting and liaison.

Decision

To note the report.

(Reference – report by the Deputy Chief Executive, submitted.)

8. Fraud Prevention

Details were provided of the Lothian Pension Fund's participation in fraud prevention initiatives which were an integral part of the control environment and the overall management of risk.

Decision

To note the report.

(Reference – report by the Deputy Chief Executive, submitted.)

9. Irrecoverable Overpayment of Pensions – Decisions made under delegated authority

Delegated authority has been provided to the Deputy Chief Executive, in certain circumstances, to write off pension overpayments up to £3,000. Details were provided of the overpayments written off under these arrangments between 1 September 2014 and 31 August 2015.

Decision

To note that the total value of pension overpayments written off between 1 September 2014 and 31 August 2015 was £4,173.15.

(Reference – report by the Deputy Chief Executive, submitted.)

10. Overpayment of Pension

The Pensions Committee would be asked to agree to write off an overpayment of pension, which arose on the death of a pensioner, of £16,254.88.

Decision

To note the report.

(Reference – report by the Deputy Chief Executive, submitted.)

11. Audit of Foreign Exchange Transaction Costs

An audit had been carried out on foreign exchange costs incurred in managing the Funds' overseas investment for the period 1 April 2014 to 31 March 2015. It was reported that there had been an improvement on the previous year which was considered to be in line with typical market ranges.

Decision

To request that the Investment Strategy Panel reviews this and future currency reports and provides its findings as part of their reporting to Committee in June each year.

(Reference – report by the Deputy Chief Executive, submitted.)

12. Risk Management Summary

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 Deputy Chief Executive, submitted.)

Pensions Audit Sub Committee

10.00 a.m., Tuesday, 15 December 2015

Agenda Planning

Item number	5.2
Report number	
Executive/routine	
Wards	All

Executive summary

This document provides Committee with an overview of the agendas 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
Single Outcome Agreement	

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Report

Agenda Planning

Recommendations

1.1 That Committee invites the Pension Board to raise any relevant matters or concerns which the Committee should consider.

1.2 That the Committee notes the agenda planning document.

Background

2.1 In order for the Committee and Pension Board to gain an overview of the content of future meetings 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 2016

Pensions Committee

- Audit Plans (external and internal)
- Audit Sub Committee Appointments
- Governance Update
- Policies/Strategies/Training
- 2015 – 2018 Service Plan Update
- 2016 – 2019 Service Plan and Budget
- Employers Participating in Lothian Pension Fund
- Risk management summary

It is proposed that the Pensions Audit Sub-Committee does not meet in March 2016. Audit plans for 2016/17 will be developed in consultation with the Convener of the Audit Sub-Committee before consideration by the Pensions Committee.

June 2016

Pensions Committee	**Pensions Audit Sub Committee**
• Lothian Pension Fund Annual Report (& Accounts) Unaudited • Statement of Investment Principles • Investment Strategy Panel Activity • Annual Investment and funding – Lothian Pension Fund/Lothian Buses Pension Fund/Scottish Homes Pension Fund • Risk management summary	• Lothian Pension Fund Annual Report (& Accounts) Unaudited • Risk management summary

Future Pensions Committee and Audit Sub Committee dates:

Pensions Committee	**Pensions Audit Sub Committee**
• Wednesday, 15 March, 2pm, Dunedin Room, City Chambers. • Monday, 27 June, 2pm, Dunedin Room, City Chambers.	• Thursday, 23 June 2016, 2pm, Dunedin Room, City Chambers

The Circulation Committee Papers

3.2 Concerns around the preparation time given for Committee papers has been raised by both Committee and Pension Board members over the past few months. Section 50B of the Local Government (Scotland) Act 1973 states that *'any document which is required'* to be *'open to inspection shall be so open at least three clear days before the meeting'. 'Clear days' exclude* weekends, the date Committee papers are issued or received or when the Committee meet. For example, Committee papers can be issued by e-mail on a Tuesday for a committee meeting scheduled to be held the following Monday.

3.3 It is acknowledged that given the complexity and length of some of the Committee papers, the Fund will endeavour to issue Committee papers at least 10 days before the Committee meet. This would be the equivalent of 7 'clear days'. However, there may be occasions when later circulation of selected papers may be necessary.

Measures of success

4.1 The Committee and Pension Board 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 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 Pension Board, comprising employer and member representatives, is integral to the governance of the Funds.

Background reading/external references

None

Alastair D Maclean

Chief Operating Officer

Deputy Chief Executive

Contact: Struan Fairbairn, Legal and Development Manager

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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
Single Outcome Agreement	
Appendices	Appendix 1 - Schedule of Committee papers Appendix 2 - http://www.legislation.gov.uk/ukpga/1973/65/section/50B

Appendix 1

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
	Policies/Strategies/Training (including revised Pension Administration Strategy biennial from March 2016) Service Plan and Budget	N/A	March
	Governance Update (as from March 2016)		March
	Audit Sub-Committee Appointments		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
	N/A	Audit of Foreign Exchange Transaction Costs	September
	Annual Report by External Auditor	Annual Report by External Auditor	December (or September if available)
	Benchmarking Report	N/A	December
	N/A	EU Tax Claims & Income Recovery	December
	N/A	Investment Income Review-Cross-Border withholding tax	December
	Environmental Social and Governance Activity (including Class Actions)	N/A	December
	N/A	Investment Controls & Compliance	December

Frequency	Pensions Committee	Audit Sub Committee	Month
Semi Annually	Employers Participating in Lothian Pension Fund	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

10.00 a.m., Tuesday, 15 December 2015

Lothian Pension Fund – Internal Audit Update 2015/16

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 September 2015 to 30 November 2015.

The activity planned for the financial year 2015/16 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 5 March 2015.

Three internal audit reviews were planned for the 2015/16 year:

- A review of the new payment system (Immediate Payments to Pensioners);
- A review of 'Compliance' arrangements; and
- A review of the procedures surrounding Externally Managed Investments.

The review of Immediate Payments to Pensioners was considered in the September Pensions Audit Subcommittee meeting. The other two reviews are considered in this report.

Links

Coalition pledges	
Council outcomes	CO26
Single Outcome Agreement	

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Report

Lothian Pension Fund – Internal Audit Update 2015/16

Recommendations

1.1 Committee is requested to:

- Note the Internal Audit activity during the period 1 September to 30 November 2015
- Note the matters arising from the Internal Audit review undertaken in this period.

Background

Internal Audit plan 2015/16

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 5 March 2015

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 the procedures surrounding Externally Managed Investments; and
- A review of 'Compliance' arrangements

2.4 The review of Immediate Payments to Pensioners was considered in the September Pensions Audit Subcommittee meeting. The other two reviews are considered in this report.

Main report

Compliance Arrangements

3.1 In order to assess the procedures & controls in place surrounding compliance with the Local Government Pension Scheme (LGPS) regulations and the European Market Infrastructure Regulations (EMIR) on derivative trading, Internal Audit conducted the following:

- Walked through the controls in place to ensure that the LPF is compliant with the LGPS & EMIR regulations;
- Identified the regulatory requirements in the LGPS Regulations and considered whether these were being complied with; and
- Identified the regulatory requirements in the EMIR Regulations applicable to the LPF and considered whether these were being complied with.

3.2 This review identified four findings of which two were graded as 'Medium' and two as 'Low'.

Summary of finding & management response	Grading
LGPS Regulations	
Holdings Accounts The LGPS Regulations state that monies held by an administrating authority (in this case CEC) for a local government pension scheme must be held in a separate bank account. Purchase ledger transactions for the LPF and miscellaneous income receipts are processed through the CEC's main bank account and posted to a nominal account in the CEC's General Ledger along with CEC's pension contributions. This nominal account is cleared down to a reserve of £3m at the end of each month with the balance transferred to the LPF bank account. This results in CEC holding between £3m & £12m of LPF monies in its bank account at any one time.	Medium
Management response Management accepted this finding and intend to utilise the opportunity of CEC's procurement of a new ERP ledger & payroll system to increase the level of banking separate between CEC & the Fund as far is practically possible without adversely impacting operations, although it is accepted that there will still be a need for some level of holding accounts with CEC.	
Treasury management All LPF bank accounts are swept at the end of each day into CEC's cash pool investment process. This results in LPF funds being pooled with CEC and ancillary organisations and placed into short to medium term deposits, cash pooled funds and overnight deposit accounts. A strict interpretation of the Regulations would suggest that this process does not comply with the requirement to keep Fund	Low

and administrating authority bank arrangements separate. However, the Regulations do not anticipate an administrating authority providing a cash investment service under a Service Level Agreement as is the case here and it is accepted that alternative interpretations of this situation could be argued.	

Management response

Management considers that the LGPS regulations are ambiguous in the area but believe that the arrangements in place are compliant with the spirit of the regulations which aims to ensure separation of banking arrangements between the Fund and its administrating authority.

Management believes that these pooled funds are cash investments rather than cash accounts and observes that the current arrangement generates a greater yield on its cash investments than would be achievable were its cash investments to be managed by a third party institution, and that this increase in yield is achieved with no additional level of risk.

Accordingly the Fund believes that on balance, the current arrangements remain the optimal approach for the Fund and no change in approach is proposed.

Internal audit do not believe that this is an unreasonable position to adopt but consider it important for a conscious and reasoned decision to have been made on this matter.

Investment limits The LGPS regulations set out the maximum proportion of a pension fund that can be invested in certain investments and with individual counterparties. The Scottish Homes Fund holds 59% of its investments in a broad portfolio managed by State Street and structured as an insurance contract, with the remaining 41% of its investments being UK Gilts. The Regulations restrict a single insurance contract to 25% of a fund's investments, resulting in the Scottish Homes Funds breaching this limit. Both the LPF and the Lothian Busses Pension Fund comply with the counterparty concentration limits set out the LGPS regulations and this matter only impacts the Scottish Homes Fund.	Low

Management response

Management accepted this finding and has established that State Street are prepared to restructure the investment holding to ensure compliance with the Regulations at no cost to the Scottish Homes Fund. As a consequence, management intend to implement this restructuring. Management also note that the passive nature of the State Street investments means that the risk to the Fund of underperformance is very limited, therefore concentration of managers is not a significant concern from an investment return perspective	
EMIR Regulations	
Derivate Trading As permitted by EMIR, the LPF has delegated reporting of its derivative trades to its custodian and fund managers; however the LPF remains responsible for reporting and is not currently verifying that reporting takes place. In addition, while the delegated reporting requirement is included in service agreements with the relevant fund managers, at the time of the audit, a signed agreement had not been reached with the Custodian. The LPF, as a financial Counter party is required to reconcile its derivatives portfolio each quarter. At the time of the audit, this had not been completed.	Medium
Management response Management accepted this finding and has moved to address the points raised. At the date of writing this was process was close to completion and management anticipate closing these points in the near future.	

For greater detail on these findings, please see the full report which is in Appendix 1.

Externally Managed Investments

3.3 In order to assess the procedures & controls in place surrounding funds placed with external fund managers, Internal Audit conducted the following:

- Walked through the process in place governing the appointment, ongoing monitoring and removal of external fund managers:
- Considered the design of the controls in place, their validity and whether there were any omissions; and
- Tested on a sample basis that the key controls identified were operating correctly.

3.4 Internal Audit did not identify any areas of concern during the audit process but did make one recommendation for management to be aware of in future activities. This recommendation surrounds ensuring the prevention of conflicts of interest when internal investment managers monitor external fund manager performance. Although we do not consider that there are any current conflicts of interest, this situation could arise if an internal investment manager held a similar remit to the external fund manager he/she was monitoring.

3.5 This recommendation has been recognised by management who intend to put in place appropriate controls to prevent any such conflict arising in future. For greater detail on this matter, please see the full report which is in Appendix 2.

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

None.

Magnus Aitken

Chief Internal Auditor

Magnus Aitken, Chief Internal Auditor

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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: Lothian Pension Fund – Compliance Arrangements Internal Audit Report Appendix 2: Lothian Pension Fund – External Managed Investments Internal Audit Report

Appendix 1

The City of Edinburgh Council
Internal Audit

Pensions Compliance

Lothian Pension Fund

Corporate Governance

November 2015

CG1509

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Contents

Although there are a number of specific recommendations included in this report to strengthen internal control, it is management's responsibility to design, implement and maintain an effective control framework, and for the prevention and detection of irregularities and fraud. This is an essential part of the efficient management of the Council. Communication of the issues and weaknesses arising from this audit does not absolve management of this responsibility. High and Critical risk findings will be raised with senior management and elected members as appropriate.

Executive summary

Total number of findings

Critical	0
High	0
Medium	2
Low	2
Advisory	0
Total	**4**

Summary of findings

The following areas of good practice were identified:

- Lothian Pension Fund and Lothian Buses Pension Fund were compliant with the statutory investment limits at 31 March 2015;
- The Pension Fund has a statement of investment principles and manages external investment managers in accordance with the LGPS regulations;
- Legal and regulatory breaches are logged. A compliance checklist is completed quarterly and reviewed by the divisional management team and circulated to all staff; and
- Staff attend regular internal and external training appropriate to their role.

The following areas for improvement were identified:

- Pension Fund monies are held in the main Council bank account. This is a breach of LGPS regulations which state that all pension fund monies should be held in a separate bank account;
- All Pension Fund bank accounts are swept into a Council Cash Fund dealing account at the end of each weekday. The pooled Pension Fund and Council funds are then placed in an overnight cash deposit account. This could be deemed to be a breach of LGPS regulations as Pension Fund monies are not fully ring-fenced from Council liabilities.
- The Pension Fund is not yet fully compliant with EU rules on derivatives trading; and
- The LGPS regulations limit investments held under a single insurance contract to 25% of the fund. At 31 March 2015, 59% of Scottish Homes invested funds were managed by State Street under a single insurance contract.

Our detailed findings and recommendations are laid out within Section 2: *Detailed findings*.

1. Background and scope

Background

The Lothian Pension Fund is a regulated entity which has to ensure that its investment management practises comply with the relevant regulatory requirements. This review focuses on the Fund's compliance with the following regulatory requirements:

- The Local Government Pension Scheme (Management and Investment of Funds) (Scotland) Regulations 2010 (LGPS Regulations); and
- European Markets Infrastructure Regulation (EMIR).

LGPS Regulations

The LGPS Regulations were introduced in 2010 and govern the management of pension fund monies by the administering authority (in this case City of Edinburgh Council). The Regulations include a requirement to operate a separate bank account for the pension fund and ring-fence pension fund monies and set limits on the ability of a pension fund or its administering council to borrow against the pension fund. They require the administering authority to set an investment strategy and publish a statement of investment principles.
The LGPS Regulations also stipulate limits on the proportion of a fund which can be invested in any one type of investment in order to encourage funds to diversify their investments and reduce risk.

EU rules on derivatives trading

European Market Infrastructure Regulation (EMIR) was introduced to regulate the European derivatives market with the aim of improving transparency and reducing risk. The key clauses of EMIR came into force in January 2013. The Fund is classified as a financial counter party but as a pension fund is exempt from some requirements until August 2017.

Currently, the Fund is obliged to report all derivative trades to a registered trade repository within one day of the trade, and ensure it has specified risk mitigation procedures in place including a protocol for dealing with disputes and a quarterly reconciliation of its derivatives portfolio.

The Fund has delegated trade reporting under EMIR to its custodian and fund managers.

2. Detailed findings

1. Holding account

Finding
The LGPS Regulations state that monies held by or received by an administering authority, in this case City of Edinburgh Council, for a local government pension scheme must be held in a separate account with a deposit taker. Purchase ledger transactions and miscellaneous income receipts are processed through the main Council bank account and are posted to a nominal holding account on the Council ledger along with Council pension contributions. The nominal holding account is cleared down to a reserve of £3 million each month, with any balance above that transferred to a Pension Fund bank account. This means that at any point in time the Council will hold between £3 million and £12 million belonging to the Pension Fund in its own bank account.

Business Implication	Finding Rating
- The Council is in breach of statutory regulations. - Pension Fund monies are not fully ring-fenced from Council liabilities.	**Medium**

Action plans	
Recommendation	**Responsible Officer**
Pension Fund monies should be fully ring-fenced and not held within Council-controlled bank accounts. Management should revisit this situation with staff from the Council's finance team and redesign the purchase ledger and miscellaneous income processes to ensure that the Council is not holding Pension Fund monies within Council-controlled bank accounts.	Investment & pensions service manager
Agreed Management Action	**Estimated Implementation Date**
In summary, the Pension Fund is committed to fully address this issue and will seize the opportunity afforded by the Council procurement of a new financial payroll and ledger system. Appropriate process amendments will therefore by implemented by the go-live date for this new software, estimated at 1 October 2016. Where possible, some changes will be introduced much sooner. It is not proposed, however, to amend the pensioner payroll processes, given the prime customer service and also efficiency drivers. Full details and rationale is provided below: The Pension Fund has operated its own separate bank accounts since 2007, this only became mandatory from 1st April 2011 under the 2010	01 October 2016

regulations.

Historically, Local Government Pension Schemes (LGPS) have been set up with a heavy reliance on the administering authorities systems and IT infrastructure. Owing to the inflexibility of these systems, it is our understanding that no Scottish LGPS administering authority is fully compliant with regulations. Audit Scotland is aware of this issue and has adopted a pragmatic approach in recognising that this may not possible, given the cost implications in securing absolute bank account segregation.

That said, Lothian Pension Fund wishes to take all practical steps to achieve regulatory compliance.

To that end, liaison with senior City of Edinburgh Council Finance staff has already effected change in that pension strain costs payable by the Council will now be made by bank transfer. Further measures are shown as follows:

1. <u>Pension Contributions</u> – to be paid via bank transfer directly to the pension fund bank account. This would also include the payroll runs of SESTRANS and the Lothian Valuation Board, which are administered by the Council. It is hoped that this can be implemented by 31 March 2016.
2. <u>Purchasing</u> - An investigation will be conducted to determine if the current Oracle purchase ledger system can generate separate BACS files for the pension funds. This will allow payments to be made from the relevant bank account (Lothian, Buses or Scottish Homes). Confirmation is awaited as to whether the Oracle system can be changed or whether it will be necessary to wait for the implementation of the new finance system (per the Council's IT contract). The new system is due to go live on 1 October 2016 and it will be configured to allow payments to be made from the appropriate bank account.
3. <u>Sales Invoicing</u> - The current sales ledger is a legacy system which feeds to Oracle. For that reason, changes to allow sales invoice receipts to be paid to the relevant pension fund bank account are likely to have to wait the new system goes live.

For the sake of clarity, Lothian Pension Fund does not propose to change the current payment procedure for the pension payroll and immediate payments. The use of a Council bank account (Payroll No 2 in Corporation 01, per the Oracle ledger) is to ensure that any unfunded (not a pension fund liability) payment does not come from a pension fund bank account. If a pension fund bank account was used, HMRC would deem such to be "unauthorised". In addition, it is administratively convenient and more cost effective to run a single pension payroll for all three funds rather than to have individual payrolls, as well as obviously beneficial from the customer's perspective, i.e. clarity and simplicity of a single pension payment and payslip.

The current arrangement requires each of the three pension funds and Council to transfer their share of the required payroll cash into the Payroll no 2 bank account. Any holding a/c balances attributable to the pension payroll are effectively cleared by the cash transfers. We do not think continuing the current procedures should pose any problems with regard to the pension regulations, which refer to monies being held or received and not to monies being expended.

Even after the changes are implemented, therefore, there will still be a need for holding accounts. For that reason, we will clear the holding account balances to zero via cash transfers on a monthly basis.	

2. EU rules on derivatives trading

Finding	
Lothian Pension Fund is obliged to comply with EU rules on derivative trading which came into force in 2013. Pension funds are exempt from certain requirements until August 2017, but are required to report trades to a registered depository within 1 day of the trade and have risk mitigation arrangements in place. We reviewed the current status of compliance with EMIR and noted: 1) As permitted by the regulations, the Pension Fund has delegated reporting of derivative trades to its custodian and fund managers. The Pension Fund does not verify that reporting is taking place as agreed. 2) An agreement with the custodian Northern Trust has been drafted which sets out the responsibilities of each party in relation to EMIR. At the date of audit the agreement was still in the process of being finalised, albeit the agreement is now fully executed by both parties. Agreements are in place with fund managers trading in derivatives. 3) As a financial counter party, the Pension Fund is required to reconcile its derivatives portfolio each quarter. Reconciliations have not yet been completed for the full portfolio.	
Business Implication	**Finding Rating**
- The Pension Fund is in breach of EU regulation. The Pension Fund is responsible for ensuring compliance with EMIR even where reporting has been delegated to a third party.	**Medium**

Action plans	
Recommendation	**Responsible Officer**
Management should satisfy themselves that the Pension Fund is compliant with current EMIR requirements, and is ready to comply with the remaining regulations by August 2017. Where reporting is delegated, this should include verifying that the custodian and/or fund manager is reporting trades in accordance with EMIR and under the terms of a signed reporting agreement. Given the low number of derivative trades, management may decide it would be prudent to verify each trade has been reported as the trade clears. The full derivatives portfolio should also be reconciled quarterly in accordance with EMIR. The reconciliation should be retained for audit purposes.	Investment & pensions service manager
Agreed Management Action	**Estimated Implementation Date**
Summary actions are: Legal agreement with the global custodian, Northern Trust, is now signed. Reconciliations will be undertaken (subject to the clarification as to delegation).	31 December 2015

Further details are provided as follows:

It needs to be recognised that the investment industry was not fully prepared when the EMIR requirements came into force. For that reason, there has been considerable uncertainty as to how the EMIR requirements would be implemented in practical terms. In addition, the number of derivative contracts entered into by the Pension Fund (either directly or via an external manager) remains low. The lack of scale means that it is not financially viable for the Pension Fund to put in place systems that would enable it to report to trade depositories directly.

The Pension Fund has, in-fact, been a "first mover" in addressing its compliance with EMIR, engaging with its external managers and custodian over the last several years to negotiate and agree suitable arrangements. The agreement with the custodian has now been finalised but was delayed for a number of reasons including this agreement having to be developed by the custodian in tandem with regulatory clarifications about EMIR being published and its own, and the Pension Fund's, regulatory review of the implications of the application of the relevant regulations. The custodian continued to comply with the essentials of the reporting agreement notwithstanding certain details requiring to be finalised. This was the position agreed between the custodian and the Pension Funds from the outset.

As regards the reconciliation requirement, ESMA (European Securities and Markets Authority) states "counterparties can agree that the calculation agent will be in charge of performing the portfolio reconciliation. In any case, each counterparty remains legally responsible for the portfolio reconciliation obligation". This would indicate that delegation should be possible.

Originally, we had been advised that it was not possible for the Pension Fund to get access to a trade depository to confirm that our trades had indeed been lodged. This lack of access also means that we do not have an independent source of information to enable us to complete reconciliations. However, on 8 October 2015, the Pension Fund's custodian advised that we could get access via the "OTC lite" service (OTC being "Over-the-Counter"). We await further information from the custodian on precisely how we can get access to this.

Finally, we note that the Pension Fund's request to include a review of its compliance with the EMIR Regulations as part of the Internal Audit process was intentionally the final stage of a thorough programme to implement 'best practice' compliance with such regulations. This is a highly technical area where the Pension Fund has very limited activity or exposure but which has raised considerable uncertainty across the industry as a whole. The findings of this report are therefore viewed as a helpful contribution to this project and, at the time of this report, have largely been dealt with. In this context, we would not view the points raised as being a "medium" risk, but note that the structure of the reporting methodology does not perhaps allow for the position to be properly recognised.

3. Treasury Management

Finding	
The LGPS Regulations state that monies held by or received by an administering authority, in this case City of Edinburgh Council, for a local government pension scheme must be held in a separate account with a deposit taker. All Pension Fund bank accounts are 'swept' into the Council Cash Fund dealing account at the end of each weekday. The pooled funds are then placed in an overnight deposit account to obtain a higher rate of interest before being returned to the Council dealing account in the morning or the following week. A strict application of the LGPS regulations would suggest LPF is non-compliant because Pension Fund monies are not fully segregated from monies belonging to the Council. However, it is accepted that the LGPS regulations do not anticipate an administering authority providing a cash investment management service to its local government pension scheme under a Service Level Agreement as is the case here. Such an arrangement with a third party provider would be clearly acceptable under the Regulations. Given the failure of the regulations to anticipate such a situation, it is accepted that alternative interpretations could be argued but it is considered that the current practice could be deemed to be non-compliant with the LGPS Regulations.	
Business Implication	**Finding Rating**
- Pension Fund monies are not fully ring fenced from Council liabilities. - The Pension Fund could be deemed to be in breach of statutory regulation.	**Low**

Action plans	
Recommendation	**Responsible Officer**
Given the ambiguities in the LGPS regulations, management should consider whether it is appropriate to continue with the current cash management arrangements, or whether they should seek to separate LPF treasury deposits in order to comply with a strict interpretation of the LGPS regulations. Management may decide altering the current arrangements would be unduly detrimental to the performance to the fund. If this is the case, approval from the Pension Board should be obtained if management elect to continue with the current arrangements.	Not Applicable
Agreed Management Action	**Estimated Implementation Date**
The Pension Fund considers that the LGPS Regulations are ambiguous in this area but believes that the arrangements in place are at the very least, compliant with the spirit of the Regulations which aim to ensure the segregation of banking arrangements between the Fund and	Not Applicable

administrating authority. The Fund considers that investment into the Cash Fund arrangement takes place at the point the money is received into the Dealing Account. This interest bearing account is therefore not in substance a “Council” bank account rather it is a Cash Fund account (an investment vehicle), representing an external investment of the monies in the same way as any other external investment. The balance in the interest bearing account, including any monies which may have been swept into it are accounted for in the same way as any other external investment by the Cash Fund. Any monies swept into the interest bearing account are not returned to the Pension Fund accounts the next day or the following week. The monies which have been swept are transferred back to the Dealing Account and re-invested as part of the daily investment process. This movement is therefore simply between different external investments. It is also important to note that the Fund receives the Cash Fund Interest Rate for that day on the investments made as part of the sweep process, not the lower interest rate on that specific account. The Fund also believes that the current arrangement generates a greater yield on its cash investments than would be achievable were its cash investments to be managed by a third party institution, and that this increase in yield is achieved with no additional level of risk. Accordingly the Fund believes that on balance, the current arrangements remain the optimal approach for the Fund and no change in approach is proposed.	

4. Investment limits

Finding	
The LGPS Regulations set out limits for the proportion of a pension fund invested in certain types of investment. The regulations state that: 1) The authority must be satisfied that the fund is managed by an adequate number of investment managers (Section 8, para 5). 2) A single insurance contract should not exceed 25% of the total value of existing investments (Schedule 1, Table). At 31 March 2015, State Street managed £89.6m of investments for Scottish Homes Fund, or 59% of the total value of the fund under an insurance contract. This concentration of assets does not occur in the Lothian Pension Fund or the Lothian Buses Pension Fund and according this finding is not relevant to these funds.	
Business Implication	**Finding Rating**
- The Scottish Homes Pension Fund is in breach of statutory regulation.	Low

Action plans	
Recommendation	**Responsible Officer**
Management should consider whether it would be appropriate to further diversify investments held by the Scottish Homes Fund in order to comply with the LGPS Regulations. Given the profile of the fund, which has no active members, and the range of investments managed by State Street, management may decide altering the current arrangements would be unduly detrimental to the performance to the fund. If this is the case, approval from the Pension Board should be obtained if management elect to continue with the current arrangements.	Investment & Pensions Service Manager
Agreed Management Action	**Estimated Implementation Date**
Scottish Homes Pension Fund's investment with State Street is via an insurance policy. Statutory regulations state that the limit is 25-35% per single insurance contract. The interpretation of what constitutes a contract differs between LGPS administering authorities. There are 3 possible views: 1) A separate contract exists for each sub fund e.g. the passive UK equities element. 2) A separate contract exists for the Passive Equity section and Passive bonds section of the Fund's policy 3) There is a single contract for the entire policy (so the fund would be in breach)	31 March 2016

The Fund's interpretation is that point 3) above does represent the current position. State Street has confirmed this and has also indicated that it would be willing, at no cost to the Fund, to restructure the current contract to ensure compliance with the LGPS investment regulations. The Fund intends to undertake this restructuring to ensure compliance with the LGPS investment regulations The passive nature of the State Street investments means that the risk to the Fund of underperformance is very limited, therefore concentration of managers is not a significant concern from an investment return perspective. It is worth noting, for the sake of proper context, that England & Wales are set to replace binding investment guidelines for local authority funds with a statement of investment policy, granting schemes greater freedom as they pool assets. Bob Holloway, who heads the Department for Communities and Local Government (DCLG) pensions unit, said he hoped a consultation on investment regulations and pooling among the 89 local government pension schemes (LGPS) in England and Wales would be published in November, allowing the department to draft new regulation by April. He has further confirmed that elements of the current Local Government Pension Scheme Regulations 2009 would be amended as part of the consultation, and singled out the regulation's schedule 1 – which imposes strict investment limits on the LGPS – as likely to be scrapped, if ministers approved. The expectation is that these changes would also be picked up in the 2010 Regulations in Scotland to ensure consistency across the LGPS in the UK. In addition, the UK Treasury has previously issued letters of comfort around areas of the 2009/2010 Investment Regulations that are recognised as not being 'fit for purpose', such as their limited approach to foreign currency exchange instruments.	

Appendix 1 - Basis of our classifications

Finding rating	Assessment rationale
Critical	A finding that could have a: • ***Critical*** impact on operational performance; or • ***Critical*** monetary or financial statement impact; or • ***Critical*** breach in laws and regulations that could result in material fines or consequences***;*** *or* • ***Critical*** impact on the reputation or brand of the organisation which could threaten its future viability.
High	A finding that could have a: • ***Significant*** impact on operational performance; or • ***Significant*** monetary or financial statement impact; or • ***Significant*** breach in laws and regulations resulting in significant fines and consequences***;*** *or* • ***Significant*** impact on the reputation or brand of the organisation.
Medium	A finding that could have a: • ***Moderate*** impact on operational performance; or • ***Moderate*** monetary or financial statement impact; or • ***Moderate*** breach in laws and regulations resulting in fines and consequences; or • ***Moderate*** impact on the reputation or brand of the organisation.
Low	A finding that could have a: • ***Minor*** impact on the organisation's operational performance ; or • ***Minor*** monetary or financial statement impact; or • ***Minor*** breach in laws and regulations with limited consequences; or • ***Minor*** impact on the reputation of the organisation.
Advisory	A finding that does not have a risk impact but has been raised to highlight areas of inefficiencies or good practice.

Appendix 2 – Terms of Reference

Corporate Governance
Lothian Pension Fund

Terms of Reference – Investment Management Compliance

To: Alastair Maclean

From: Magnus Aitken
Chief Internal Auditor
Date: 8 September 2015

This review is being undertaken as part of the 2015/16 internal audit plan approved by the Pensions Committee in March 2015.

Background

The primary objective of the Lothian Pension Fund, as set out in the Statement of Investment Principles, is to ensure that all members and their dependants receive their benefits when they become payable. The Fund has developed a long-term investment strategy to meet this objective, and maximise investment return while controlling risk and cost.

The Fund is a regulated entity which has to ensure that its investment management practises comply with the relevant regulatory requirements. This review focuses on the Funds compliance with the following regulatory requirements:

- The Local Government Pension Scheme (Management and Investment of Funds) (Scotland) Regulations 2010 (LGPS Regulations); and
- European Markets Infrastructure Regulation (EMIR).

Scope

The scope of this review will be to assess the design and operating effectiveness of the Council's controls relating to compliance with the LGPS Regulations and EMIR.

The sub-processes and related control objectives included in the review are:

Sub-process	Control Objectives
Governance & Reporting	• There is a compliance culture in place with a clear 'tone at the top' from senior management; • The Fund are aware of their compliance status; • The Fund are aware of future regulatory change that may have an impact on them; • All potential breaches are escalated to senior Fund management; and

	• Any breaches are reported to the Pensions Committee.
LPGS - Regulations	• The Fund complies with the regulations surrounding *'Management of the pension fund'*; • The Fund complies with the regulations surrounding *'Investment Managers'*; and • The Fund complies with the regulations surrounding *'Investment & use of pension fund money'*.
EMIR	• All Over-The-Counter (OTC) derivatives to which the Fund becomes party are reported to a registered Trade Repository; and • Risk mitigation procedures are in place for non-centrally cleared OTC derivatives.

Limitations of Scope

The scope of our review is outlined above. Testing will be undertaken on a sample basis for the period 1 April 2015 to 31 August 2015 where applicable. Testing will be restricted to procedures surrounding compliance with the LPGS regulations and EMIR. It will not cover other areas of regulation the Fund is required to comply with.

Approach

Our audit approach is as follow:

- Obtain an understanding of externally managed investments through discussions with key personnel and review of working papers,
- Identify the key risks relating to externally managed investments,
- Evaluate the design of the controls in place to address the key risks,
- Test the operating effectiveness of the key controls.

Internal Audit Team

Name	Role	Contact Details
Magnus Aitken	Chief Internal Auditor	0131 469 3176
Gemma Dalton	Internal Auditor	0131 469 3077

Key Contacts

Name	Title	Role	Contact Details
Alastair Maclean	Chief Operating Officer Deputy Chief Executive	Review Sponsor	0131 529 4136
Clare Scott	Investment and Pensions Service Manager	Key contact	0131 469 3865
John Burns	Pensions and	Key contact	0131 469 3711

	Accounting Manager		
Struan Fairbairn	Legal and Development Manager	Key contact	0131 529 4689
Esmond Hamilton	Financial Controller	Key contact	0131 469 3521

Timetable

Fieldwork Start	Monday 14 September 2015
Fieldwork Completed	Friday 2 October 2015
Draft report to Auditee	Wednesday 7 October 2015
Response from Auditee	Wednesday 14 October 2015
Final Report to Auditee	Friday 30 October 2015
Final report available for presentation to the Governance, Risk and Best Value Committee	November 2015

Note: Actual progress against the dates set out above will be recorded on the face of the final report, along with commentary explaining any discrepancies.

Appendix 1: Information Request

It would be helpful to have the following available prior to our audit or at the latest our first day of field work:

Governance & reporting

- List of potential and actual breaches identified in period 1 April 2015 to 31 August 2015
- Minutes of Pension Committee meetings in the period 1 April 2015 to 31 August 2015

LGPS regulations

- Details of any amounts borrowed by the Council from Lothian Pension Fund in the period 1 April 2015 to 31 August 2015
- Proportion of fund money invested in each category of investments as described in Part 1, Schedule 1 to the LGPS regulations at 31 August 2015

EMIR

- List of OTC derivatives held in the period 1 April 2015 to 31 August 2015, with trade dates.
- Agreements with fund managers and Northern Trust about confirming delegated reporting requirements and activities under EMIR.

This list is not intended to be exhaustive; we may require additional information during the audit which we will bring to your attention at the earliest opportunity.

Appendix 2

The City of Edinburgh Council
Internal Audit

Externally managed investments

Lothian Pension Fund

Corporate Governance

Final Report

October 2015

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Contents

Although there are a number of specific recommendations included in this report to strengthen internal control, it is management's responsibility to design, implement and maintain an effective control framework, and for the prevention and detection of irregularities and fraud. This is an essential part of the efficient management of the Council. Communication of the issues and weaknesses arising from this audit does not absolve management of this responsibility. High and Critical risk findings will be raised with senior management and elected members as appropriate.

Executive summary

Total number of findings

Critical	0
High	0
Medium	0
Low	0
Advisory	1
Total	**1**

Summary of findings

The following areas of good practice were identified:

- Lothian Pension Fund have appointed an Independent Professional Observer to support the Pensions Committee and enable them to make informed decisions about investment strategy and monitor performance effectively;
- Investment performance as reported by the external investment manager is validated using an independent performance measurer;
- Investment performance is monitored by the Investment Strategy Panel in their quarterly meetings. Management information is clear and comprehensive; and
- The Investment Strategy Panel completes an annual self-review of its effectiveness as a committee. The outcome of this review is reported to the Pensions Committee.

One area for improvement was identified:

- Management may wish to review the allocation of investment manager contracts to ensure that portfolio managers do not review the performance of investment managers trading in a similar range of products.

Our detailed finding and recommendation is laid out within Section 2: *Detailed findings*.

1. Background and scope

Background

The primary objective of the Lothian Pension Fund, as set out in the Statement of Investment Principles, is to ensure that all members and their dependants receive their benefits when they become payable. The Funds have developed a long-term investment strategy to meet this objective, and maximise investment return while controlling risk and cost.

At 31 March 2015, the Funds held assets of £5.1 billion in a diverse range of investments, including global equity, private markets, infrastructure and property. Around 40% of the Funds' investments are managed externally.

Governance

The Pensions Committee is responsible for setting the Funds' investment strategy, in the form of the Statement of Investment Principles which is reviewed annually. The Funds have appointed an independent professional observer to support the Committee and enable to them to make informed decisions about the investment strategy and monitor investments appropriately. Her role is to help the Committee challenge officers' advice and the performance of the fund, and to provide an independent source of information and advice on investment management and the financial sector.

Responsibility for implementing the investment policy and strategy decided by the Pensions Committee is delegated to the Director of Corporate Governance, who is supported by the Investment Strategy Panel.

Appointments

The Funds appoint new investment managers following a competitive tender process in line with corporate procurement policy and EU legislation. All new appointments are authorised in accordance with the Council's Scheme of Delegation.

No external investment managers have been appointed since April 2013.

Monitoring

The Investment Strategy Panel reviews the performance of investment managers each quarter. A 'traffic light' report is presented to the Panel which scores each investment manager against five criteria: investment performance; investment strategy; team; client base and ownership.

The investment management agreement signed by each investment manager stipulates that they must provide performance data quarterly and attend a meeting with Lothian Pension Fund up to four times a year. The performance rating is based on these discussions with the investment manager, as well as an assessment provided by an independent performance measurer, Portfolio Evaluation.

Termination

The Investment Strategy Panel may decide to end a contract with where the investment manager is not meeting the performance targets or delivering the agreed investment process, or where the portfolio no longer fits with the Funds' investment strategy. The investment management agreement allows the Funds to terminate an arrangement with the investment manager at any time.

An investment management agreement was last terminated in November 2014.

2. Detailed findings

1. Role of the portfolio manager

Finding	
Lothian Pension Fund portfolio managers act as contract managers for the external investment managers, and are responsible for monitoring investment performance and preparing the quarterly reports for the Investment Strategy Panel. As highlighted by both a member of the Investment Strategy Panel and one of the investment managers, this may result in a conflict of interest where the portfolio manager trades in a similar range of investments to the investment manager. The impact of this is mitigated by the high level of scrutiny of both internally and externally managed investments by the Investment Strategy Panel.	
Business Implication	**Finding Rating**
- Perception of a conflict of interest where portfolio managers report on the performance of external investment managers with a similar remit; and - There is a risk that portfolio managers use the investment manager's strategy and data in their own investment activity. This would be contrary to expected ethical conduct and would reduce the level of risk diversification in the LPF portfolio.	**Advisory**

Action plans	
Recommendation	**Responsible Officer**
Management should review the allocation of investment manager portfolios, and consider whether there should be greater segregation to ensure that portfolio managers are not responsible for investment managers trading in a similar range of investments.	Bruce Miller, Investment Manager
Agreed Management Action	**Estimated Implementation Date**
We recognise the potential for a conflict of interest. The Investment Strategy Panel will review the allocation of portfolios annually and will put appropriate controls in place where an overlap in strategies and shareholdings is identified, such as reassigning responsibility for monitoring the external portfolio. We do not consider this to be a current risk, however, as the Fund does not use external managers to run portfolios that are similar to internal strategies. The issue discussed by Investment Strategy Panel and highlighted by the investment manager reflect the fact that both the internal portfolio manager and the external investment manager that he monitors run global equity portfolios. However, the strategies are quite different -	

one runs a 'growth' strategy and the other a 'value' approach and there is no overlap in shareholdings. The impact of a conflict of interest is also reduced because the external fund manager's performance is evaluated by an external performance measurer as well as by the internal manager. The traffic light monitoring reports also receive a high level of scrutiny by the investment management team, including the Investment Manager, before they are also scrutinised Investment Strategy Panel.	

Appendix 1 - Basis of our classifications

Finding rating	Assessment rationale
Critical	A finding that could have a: • ***Critical*** impact on operational performance; or • ***Critical*** monetary or financial statement impact; or • ***Critical*** breach in laws and regulations that could result in material fines or consequences***; or*** • ***Critical*** impact on the reputation or brand of the organisation which could threaten its future viability.
High	A finding that could have a: • ***Significant*** impact on operational performance; or • ***Significant*** monetary or financial statement impact; or • ***Significant*** breach in laws and regulations resulting in significant fines and consequences***; or*** • ***Significant*** impact on the reputation or brand of the organisation.
Medium	A finding that could have a: • ***Moderate*** impact on operational performance; or • ***Moderate*** monetary or financial statement impact; or • ***Moderate*** breach in laws and regulations resulting in fines and consequences; or • ***Moderate*** impact on the reputation or brand of the organisation.
Low	A finding that could have a: • ***Minor*** impact on the organisation's operational performance ; or • ***Minor*** monetary or financial statement impact; or • ***Minor*** breach in laws and regulations with limited consequences; or • ***Minor*** impact on the reputation of the organisation.
Advisory	A finding that does not have a risk impact but has been raised to highlight areas of inefficiencies or good practice.

Appendix 2 – Terms of Reference

Corporate Governance
Lothian Pension Fund

Terms of Reference – Externally managed investments

To: Alastair Maclean

From: Magnus Aitken
Chief Internal Auditor

Date: 4 September 2015

This review is being undertaken as part of the 2015/16 internal audit plan approved by the Pensions Committee in March 2015.

Background

The primary objective of the Lothian Pension Fund, as set out in the Statement of Investment Principles, is to ensure that all members and their dependants receive their benefits when they become payable. The Funds have developed a long-term investment strategy to meet this objective, and maximise investment return while controlling risk and cost.

At 31 March 2015, the Funds held assets of £5.1 billion in a diverse range of investments, including global equity, private markets, infrastructure and property. Around 40% of the Funds' investments are managed externally.

Scope

The scope of this review will be to assess the design and operating effectiveness of the Council's controls relating to investments managed externally.

The sub-processes and related control objectives included in the review are:

Sub-process	Control Objectives
Governance	• There are governance structures in place which allow sufficient scrutiny of the performance of the externally managed funds throughout the year. • Information provided to the Investment Strategy Panel and Pensions Committee is accurate and enables members to monitor performance effectively. • Members of the Investment Strategy Panel and Pensions Committee have the appropriate experience and skills, and receive support and training to enable them to make informed decisions about investment

	strategy.
Appointment	• External investment managers are appointed in line with the investment objectives of the Fund. • New appointments are authorised in accordance with the Council's Scheme of Delegation. • The selection of investment managers complies with corporate procurement policy and EU directives on competitive tendering. • There is a formal Investment Management Agreement in place with each external fund manager.
Monitoring	• Performance measures are agreed with each external manager which allow LPF to assess and compare performance across their investment portfolio. • Performance information is meaningful and accurate. • Performance is monitored throughout the year. • Appropriate action is taken where investment managers do not meet agreed targets and investment objectives.
Termination	• Arrangements with external investment managers are terminated where they no longer support the Investment Strategy.

Limitations of Scope

The scope of our review is outlined above. Testing will be undertaken on a sample basis for the period 1 April 2015 to 31 August 2015 where applicable.

Approach

Our audit approach is as follow:

- Obtain an understanding of externally managed investments through discussions with key personnel and review of working papers,
- Identify the key risks relating to externally managed investments,
- Evaluate the design of the controls in place to address the key risks,
- Test the operating effectiveness of the key controls.

Internal Audit Team

Name	Role	Contact Details
Magnus Aitken	Chief Internal Auditor	0131 469 3176
Gemma Dalton	Internal Auditor	0131 260 4057

Key Contacts

Name	Title	Role	Contact Details
Alastair Maclean	Chief Operating Officer Deputy Chief Executive	Review Sponsor	0131 529 4136

Clare Scott	Investment and Pensions Service Manager	Key contact	0131 469 3865
John Burns	Pensions and Accounting Manager	Key contact	0131 469 3711
Bruce Miller	Investment Manager	Key contact	0131 469 3866

Timetable

Fieldwork Start	Monday 7 September 2015
Fieldwork Completed	Friday 25 September 2015
Draft report to Auditee	Wednesday 30 September 2015
Response from Auditee	Wednesday 7 October 2015
Final Report to Auditee	Friday 23 October 2015
Final report available for presentation to the Governance, Risk and Best Value Committee	October 2015

Note: Actual progress against the dates set out above will be recorded on the face of the final report, along with commentary explaining any discrepancies.

Pensions Audit Sub Committee

10.00 a.m., Tuesday, 15 December 2015

Investment Controls and Compliance

Item number	5.4
Report number	
Executive/routine	
Wards	All

Executive summary

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

- **Investment controls:** the Fund has now finalised its process of reviewing and implementing the appropriate recommendations of the external consultant following a review of the in-house investment operations in December 2013.
- **Financial Conduct Authority (FCA) authorisation:** the FCA application was approved for submission by the LPFI board on 15 October 2015 and the Fund will continue to liaise with the FCA during the coming months to facilitate a conclusion to this process.
- **Investment pooling**: the UK Government has recently announced a national agenda to ensure the effective collaboration of LGPS funds in England and Wales to pool their investments. The Fund, together with a number of internally managed pension funds, is exploring the options for collaboration.
- **Wider financial services regulation:** draft European driven regulation within the UK may have a substantial impact on LGPS fund's ability to operate in particular investment markets. The Fund's current strategy to operate and develop an in-house investment team makes it well placed to work within these regulations.

Links

Coalition pledges	
Council outcomes	CO26
Single Outcome Agreement	

•EDINBVRGH•
THE CITY OF EDINBURGH COUNCIL

Report

Investment Controls and Compliance

Recommendations

1.1 That Committee invites the Pension Board to raise any relevant matters or concerns which the Committee should consider.

1.2 That Committee notes the progress made in relation to implementing the recommendations of the external consultant, the establishment of an FCA authorised structure, the Fund's involvement in the investment pooling discussions and the potential impact of new financial service regulation on the Fund.

Background

2.1 The Fund instructed a review of its in-house investment operations by a consultant in December 2013 in order to ensure that its systems and controls were fit for purpose and also to benchmark them against those for full FCA compliance (albeit not currently a requirement for the Fund).

2.2 The consultant's report concluded that the Fund's systems were fit for its current purpose, but that certain improvements could be made and would be required in anticipation of it operating an FCA authorised vehicle. The Fund has since been phasing in appropriate operational and compliance improvements generally and in anticipation of LPFI's application for FCA authorisation. The Committee last received an update on the Fund's progress in this regard on 25 March 2015.

2.3 This report should also be read in conjunction with the report for Pensions Committee on 16 December as regards the costs associated with the ongoing initiatives and the Risk Management Overview for a more detailed update on the associated risk analysis.

Main report

Investment controls and consultant's recommendations

3.1 *Human capital:* Following the consultant's recommendation to put in place arrangements that would allow staff involved in the in-house investment function to be placed on terms and conditions appropriate to their roles (including extended notice periods), the Fund has established a special purpose staffing vehicle, LPFE Limited ("LPFE"), and transferred the employment of those staff into LPFE. LPFE has now appointed an external HR provider (121 Solutions

Limited) to provide it with dedicated services. The LPFE board is expected to meet prior to the meeting of the Pensions Committee in order to discuss and agree the implementation of the remainder of its employer systems and procedures, including any revisions to the current remuneration policy and terms and conditions to ensure they are appropriate for the employment of investment professionals.

3.2 *Transaction execution:* An electronic trading platform is being put in place to ensure that dual authorisation of a trade takes place. The system also requires unique trader identifications which will support improved compliance in this area. The Fund will not, however, be looking to implement a full central dealing desk due to this not being required, or cost effective, for its current volumes of trading and because the Fund will not be managing the assets of any other external parties.

3.3 *Transaction testing:* Transaction testing is undertaken and signed off post-trade by the front office. This testing has also now been included within the Fund's compliance checks. The introduction of electronic trading will also permit transaction cost analysis via Bloomberg.

3.4 *Operational due diligence:* The Fund's process for reviewing external managers has been extended and amended to include regular reviews of those managers on its current framework but with whom the Fund does not have an existing mandate. These reviews will now also formally include an assessment of the appropriateness of the underlying manager's operational infrastructure. Similarly, the Fund's review process for its custodian, currently The Northern Trust Company, has been updated so that it includes at least one "on-site" review per year. This will ensure we are aware of their on-site capabilities. Two such visits have subsequently taken place with satisfactory observations and outcomes.

3.5 *Telephone recording:* A telephone recording system is now in operation across the Fund and has been fully tested. Discussions are currently ongoing around how long the resulting call data should be retained for.

3.6 *Internal service level agreements:* The Fund is in the process of updating its existing internal service level agreement for cash management with the City of Edinburgh Council's ("**CEC**") treasury team. The Fund is also looking to put in place internal service level agreements for certain other key services which it receives from CEC divisions, such as IT, payroll/treasury etc.

FCA authorisation

3.7 The board of LPFI approved the business plan and FCA application for submission on 15 October 2015, subject to it being updated to include the appoint of a non-executive director to the board and to make some minor amendments to the proposed investment services agreement between CEC and LPFI. These changes have now been made with the intention that the application will be submitted in early course. The additional appointment of a non-executive to the LPFI board is in line with the Corporate Governance Code and is viewed as an important means of supporting the senior management of the investment function and an additional check and balance on its governance. The Fund will keep Committee updated on the appointment process.

3.8 The Fund will continue to liaise with the FCA over the coming months in order to facilitate the process and will keep the Committee up to date on developments. The Fund would anticipate that the FCA will take somewhere between four and six months to process the application, although it could potentially take longer.

3.9 By way of a reminder, LPFI is seeking limited investment advisory and arranging permissions in support of the development of its own internal in-house investment function (e.g. in collaborating with other institutional investors, unitising its internal strategies for the benefit of employers and for operational and other governance improvements). LPFI will not therefore be seeking permissions to manage or hold third party assets as part of this process.

LGPS Investment pooling

3.10 The UK Government has recently announced a national agenda to ensure the effective collaboration of LGPS funds in England and Wales to pool their investments in order to generate cost efficiencies and savings for the scheme and to facilitate infrastructure investment within the United Kingdom. This was most recently formalised in the summer budget of 2015 (section 2.19), a subsequent conference speech by the Chancellor and consultations released on 25 November 2015.

3.11 The Fund continues to monitor the position south of the border and is directly involved in a project with other LGPS funds, being coordinated by Hymans Robertson in consultation with the UK Treasury Department and the Department for Communities and Local Government (DCLG), to inform the best outcomes and approach to implement investment pooling. This includes a detailed analysis of the benefits of internal management and the different ways in which LGPS funds could collaborate and further exploit the benefits of internal management. The Fund believes that its existing strategy and initiatives makes it well placed to adapt to any future change and collaborate effectively with other LGPS funds if that would be appropriate. Conclusions of the project will be reported to Committee for consideration in due course.

3.12 In Scotland, a review of structure of the Local Government pension Scheme is expected to be taken forward by the Scheme Advisory Board (SAB). The scope of this review is not yet clear.

Wider financial services regulation

3.13 Some important European/financial services legislation is currently under consultation which may significantly impact on the types of investment that local authority administering authorities can invest in and could result in many LGPS schemes having to divest from certain otherwise illiquid investments at a substantial cost to their respective stakeholders. In short, the Markets in Financial Instruments Directive (2014/65/EU) (“MiFID II”) is proposing that local government administering authorities will default to being classified as ‘Retail Clients’ rather than ‘Professional Clients’, resulting in their being regulated within the more onerous and restrictive retail regulatory regime. This classification would be based on such local authorities not having sufficient investment knowledge and expertise to properly assess and make their own investments in particular sectors. It would effectively exclude such funds from the more sophisticated private markets (e.g. private equity/infrastructure/timberland/debt funds, co-investments, single asset opportunities etc.) and therefore meaningfully reduce their investment universe and ability to diversify their investment strategies. Whilst the detail is yet to be determined and finalised, the Fund is currently of the view that it would be able to ‘opt out’ and continue to benefit from classification as a ‘Professional Client’, given the nature of its current structure and in-house investment team.

3.14 The Fund’s current strategy of retaining an in-house investment function, and further developing this capability through its new structure, will make it well placed to deal with this (and any other) regulatory change. This will allow the Fund to mitigate the potentially significant costs and constraints that such regulation could potentially impose.

3.15 The Fund will continue to closely monitor the position and keep the Committee and Pension Board appraised of this and any other equivalent area of regulatory development.

Measures of success

4.1 That the Fund continues to develop efficiencies for the benefit of its members, employer bodies and the taxpayer, while mitigating any risk associated with the necessary arrangements.

4.2 That the Fund seeks to improve its service provision and adapts its operations to the wider structural and regulatory changes facing public sector funds.

Financial impact

5.1 There is no direct financial impact associated with the update of progress in relation to the matters set out in this report.

5.2 A report elsewhere on the Committee’s agenda shows how the Fund’s investment costs compare favourably (approximately £5.5m p.a.) with an average pension fund, largely due to its internal management operations.

5.3 The improvements in day-to-day investment controls have been met from within existing budgets.

5.4 The Fund has incurred approximately £64,000 in legal, accounting and tax advisory costs in order to establish LPFI and LPFE and operate them to this point. The Fund has saved a very significant amount of costs (while continuing to mitigate risks through seeking appropriate levels of external advice) through its ability to design the structure, manage external advisors and put in place the necessary documentation/systems etc. through its internal legal and accounting expertise. The Fund has also incurred other lower level costs in relation to implementing bespoke payroll, HR and time-recording systems for LPFE, but these have been absorbed within existing budgets.

5.5 An update on the impact of the review of employer systems and procedures, including any revisions to the current remuneration policy and terms and conditions, will be provided to Committee following the LPFE Board meeting.

5.6 There continue to be very significant cost implications in not ensuring that the Fund's internal investment operation is best placed to adapt to the market and regulatory changes currently affecting the sector.

Risk, policy, compliance and governance impact

6.1 The review of investment operations highlighted areas for improvement in governance and risk and these have been implemented.

6.2 In particular, the Fund needs to continue to ensure that its governance processes and procedures (including delegations, signing authorities etc.) adapt to any organisational changes within the Council and are sufficient to allow it to continue to carry out its business effectively and to exercise its functions with sufficient fiduciary independence.

6.3 There are significant risk and compliance considerations for the Fund to consider around any implementation of MIFID II within the United Kingdom in the manner currently proposed.

Equalities impact

7.1 None.

Sustainability impact

8.1 The review of investment operations and the implementation of actions resulting from that review are intended to secure the long-term sustainability of the internal investment operations for the benefit of the pension funds.

Consultation and engagement

9.1 The Pension Board, comprising employer and member representatives, is integral to the governance of the Funds.

Background reading/external references

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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
Single Outcome Agreement	
Appendices	

Pensions Audit Sub Committee

10.00 a.m., Tuesday, 15 December 2015

EU and Other Tax Claims

Item number	5.5
Report number	
Executive/routine	
Wards	All

Executive summary

This report summarises activity on EU and other 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 £108.0k to a total of £1,370.1k. Progress continues on the various outstanding claims.

Links

Coalition pledges	
Council outcomes	CO26
Single Outcome Agreement	

Report

EU Tax Claims and Income Recovery

Recommendations

1.1 That Committee invites the Pension Board to raise any relevant matters or concerns which the Committee should consider.

1.2 Note the report and highlight any points it would like to raise at the Pensions Committee on 16 December 2015.

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.

2.3 In addition, the report covers a claim made in the USA in respect of Master Limited Partnerships.

Main report

Claims - Manninen / Foreign Income Dividends

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 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 Lothian Pension Fund 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 – the substantive issue. • 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 out of time issue.
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 (CJEU).
December 2013	Court of Appeal rejects the claimants' appeal on the out of time issue (based on UK domestic law). A further hearing by the Court of Appeal has been set for February 2015 to consider HMRC's appeal on the substantive issue and the out of time issue (based on European law). It is possible that the Court of Appeal will refer certain issues to the CJEU at this hearing.
June 2015	The second Court of Appeal hearing took place in June 2015 concerning EU law based "out of time" arguments and the substantive issue.

July 2015	The Court of Appeal hands down its judgement: 1. The original decision on the out of time issue is upheld and the Court has refused to allow an appeal to the CJEU on this issue. 2. On the substantive issue the Court has decided to refer matters to the CJEU.
November 2015	On the out of time issue an application for permission to appeal has been submitted to the Supreme Court directly. The outcome of this application is awaited. On the substantive issue the Court of Appeal has agreed the specific questions that will be referred to the CJEU. It is expected that the CJEU will take up to 2 years to issue a judgement.

3.7 Fees incurred to date, by Lothian Pension Fund, on these claims amount to £58.2k (£54.5k as at the last update to Committee in December 2014). 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 - 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 Committee of October 2007 approved making claims under the principle established in the Fokus Bank case. Claims currently estimated at around £3.2m 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	278.9	278.9	All claims paid - final instalment received in February 2013 (£73k)
Spain	2004 2009	568.2	568.2	All claims paid - final instalment received in March 2015 (£102k)

Country	Claim Period From / To	Estimated Amount Claimed £'000	Amount Received £'000	Notes
Active Claims				
France	2005 2009	551.4	-	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. KPMG will complete a comparability analysis in conjunction with Lothian in Q4 2015 to demonstrate the pension scheme is in a similar situation to the test claimant. The French Tax Authority has indicated informally that they are keen to resolve pension fund claims and KMPG have agreed an approach with them to do so.
Germany	2003 2010 2011 2014	764.0 95.9	-	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. There have been delays in KPMG appointing a test claimant. However it is hoped that one will be agreed in the next few months. At which point the issue of repayment will be tested in the German Courts. In August 2015, following a competitive tender, Deloitte LLP was appointed to make additional claims in respect of the calendar years 2011 to 2014 inclusive.
Italy	2004 2010	426.3	-	The Italian Tax Authority has taken no action in respect of claims and it seems litigation will be required for a resolution. There has been little appetite amongst claimants to date to fund a test case although KPMG are keen to do so.

Country	Claim Period From / To	Estimated Amount Claimed £'000	Amount Received £'000	Notes
				KPMG believe claimants prefer to concentrate efforts on France and Germany before considering Italy.
TOTAL		**3,207.7**	**1,370.1**	

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 £369.4k (£367.7k as at the meeting of December 2014). Costs are higher for the Fokus Bank type claims because of the need to file claims separately in individual EU countries.

Claims - 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 £3,928.6k on behalf of Lothian Pension Fund have been lodged with HMRC. Following a competitive tender in the summer of 2015, Deloitte LLP has been appointed to make an additional claim for around £942k, covering the 2013 calendar year. This increases the total claimed to of £4,870.6k.

3.15 KPMG has appointed a firm of solicitors (Pinsent Masons) to pursue recovery. A brief chronology of events to date is provided in the table below:

Date	Event
March 2013	An initial hearing of the First-tier Tribunal (FTT) took place.
During 2014	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.
November 2015	The case was heard by the FTT (sitting in London between 2 and 5 November 2015). A decision was reserved by the Tribunal and will be handed down at a later date.

3.16 Fees incurred to date on these claims amount to £116.3k (£100.4k as at the meeting of December 2014). Potential subsequent referrals are estimated to cost £20k for each legal stage.

Claims – Master Limited Partnerships

3.17 This claim is against the US tax authorities. The withholding tax (WHT) audit reported to Committee in December 2014 noted that there were 21 income receipts in the USA that had suffered a tax deduction of 35%. The WHT rate for dividends in the USA is 0%. However, the 35% deductions were in respect income distributions from Master Limited Partnerships.

3.18 Following a competitive tender in the summer of 2015, a firm of accountants has been appointed to make a tax claim in the USA. The value of the claim for the year ended 31 December 2014 is estimated to be around $576,000. Progress on this and the other claims will be reported on an annual basis.

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 Tax claims totalling in excess of £11m have now been lodged with the relevant tax authorities. Professional fees amounting to £543.9k have been paid 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 £826.2k. 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	58.2
Fokus Bank	3,207.7	1,370.1	1,837.6	369.4
Manufactured Dividends	4,870.6	Nil	4,870.6	116.3
Master Limited Partnerships	379.2	Nil	379.2	Nil
	11,084.2	**1,370.1**	**9,714.1**	**543.9**

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 Pension Board, 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
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Pensions Audit Sub Committee

10.00 a.m., Tuesday, 15 December 2015

Global Custody Services Performance

Item number	5.6
Report number	
Executive/routine	
Wards	All

Executive summary

This report presents the Key Performance Indicator Report for the 12 months ended 30 September 2015 provided by the Funds' 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 sufficient standard. As discussed in the report, there have been a few examples of deterioration in the timeliness of some services. This has not impacted the effectiveness of the Pension Funds and the issues have been discussed with Northern Trust.

Links

Coalition pledges	
Council outcomes	CO26
Single Outcome Agreement	

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Report

Global Custody Services Performance

Recommendations

1.1 That Committee invites the Pension Board to raise any relevant matters or concerns which the Committee should consider; and

1.2 Note the report and highlight any points it would like to raise at the Pensions Committee on 16 December 2015.

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:

- Reconciling 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 2015. 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 30/9/15	Amber (Previous Report: Green)
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 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. For the year end up to 30 September 2015, on three occasions the sign off period was after the 14 day target. On each occasion queries had been submitted by the Funds' staff which resulted in the delay of the final sign off. The queries were raised to improve the accuracy of the monthly valuations and are an essential part of quality assurance role played by the Funds' staff. Working proactively with Northern Trust helps to minimise future problems.

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 30/9/15	Amber (Previous Report: Green)
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. The delays mentioned above, in the comments on the month end valuation performance indicator have had a knock on effect in completion of the monthly financial reporting on three occasions. Fortunately, there were no delays at the year end.

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 97.19%) 96.40%
Comments	During the period there were a total of 6,446 trades of which 6,214 (96.40%) were settled on time. Of the 232

	trades settled late, 205 were purchases and 27 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 98.35%) 98.65%
Comments	The performance indicator is based on the number of income collections rather than their value. During the period there were a total of 2,821 income collections, 2,783 (98.65%) 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 46

	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 96.24% (Previous Report: Amber 95.50%)
Comments	During the period there were 559 corporate actions, 538 (96.24%) 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 one 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.

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 2015/16 is £352k. 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. Northern Trust currently provides custody services to 36% of the LGPS market in the UK and has been named Pension Fund Custodian of the Year in the Custody Risk European Awards for 2015. In addition, Northern Trust has retained a high credit rating (AA-) for many years and has not been involved in high profile litigation cases with clients (in contrast to other global custodians).

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 Pension Board, 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
Single Outcome Agreement	
Appendices	None

Pensions Audit Sub Committee

10.00 a.m., Tuesday, 15 December 2015

Investment Income Review Cross Border Withholding Tax

Item number	5.7
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. There is positive news on the payment of claims by the Fund's largest debtor – Switzerland.

Links

Coalition pledges	
Council outcomes	CO26
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Report

Investment Income Review Cross Border Withholding Tax

Recommendations

1.1 That Committee invites the Pension Board to raise any relevant matters or concerns which the Committee should consider; and

1.2 Note the report and highlight any points it would like to raise at the Pensions Committee on 16 December 2015.

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 2014/15 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.

The Role of the Custodian

2.7 The custodian appointed for the three pension funds is Northern Trust (NT). In addition to the vital role 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 – Lothian Pension Fund and Lothian Buses Pension Fund

2.8 The tables below show the movement in the reclaimable tax balances during the 2014/15 and 2013/14 financial years for both Lothian Pension Fund and Lothian Buses Pension Fund.

Lothian Pension Fund	**2014/15 £**		**2013/14 £**
Brought Forward 1 April	2,531,042.23		1,842,564.05
Recoverable tax accrued during year	2,062,513.96		1,751,330.62
Claims paid during year	(656,146.78)		(1,062,852.44)
Carried Forward 31 March	3,937,409.41		2,531,042.23

Lothian Buses Pension Fund	**2014/15 £**		**2013/14 £**
Brought Forward 1 April	320,259.30		286,235.33
Recoverable tax accrued during year	189,959.71		168,919.59
Claims paid during year	(34,037.42)		(134,895.62)
Carried Forward 31 March	476,181.59		320,259.30

2.9 In the case of both funds there have been increases in the amount of recoverable tax accruing during the year. However, in both cases the claims paid have fallen considerably due to delays experienced with the Swiss claims. 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.

2.10 The year end recoverable tax balances at 31 March 2015 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 31/3/15 £	Number of Dividends 31/3/15		Reclaim Amount 31/3/14 £	Number of Dividends 31/3/14
Austria	34,795.27	31		23,663.09	31
Belgium	30.45	1		41,106.58	5
Canada	-	-		15,117.68	7
Denmark	1,041.69	3		979.88	1
France	6,279.24	4		3,196.29	3
Germany	17,720.39	10		11,958.49	4
Israel	1,613.34	1		-	-
Japan	-	-		24,188.83	10
Netherlands	55,868.52	9		34,911.14	6
Norway	240,655.91	12		115,841.23	10
Poland	13,544.28	2		10,934.80	1
Russian Federation	23,301.70	1		-	-
South Africa	532.56	1		-	-
Spain	245,452.03	67		-	-
Switzerland	3,078,224.96	77		2,100,482.41	61
United Kingdom	216,945.77	17		146,100.43	14
United States	1,403.30	2		2,561.38	3
Grand Total	**3,937,409.41**	**238**		**2,531,042.23**	**156**

Lothian Buses Pension Fund	Reclaim Amount 31/3/15 £	Number of Dividends 31/3/15		Reclaim Amount 31/3/14 £	Number of Dividends 31/3/14
Canada	-	-		783.68	4
Denmark	91.72	1		243.32	1
Germany	4,302.45	2		3,194.38	2
Japan	4,343.42	1		499.52	1
Netherlands	5,051.26	2		419.08	1
Norway	34,592.56	7		7,025.68	4
Spain	2,186.45	1		-	-
Switzerland	414,841.70	18		307,589.08	12
United Kingdom	10,772.03	3		504.56	1
Grand Total	**476,181.59**	**35**		**320,259.30**	**26**

2.11 For Lothian Pension Fund, Switzerland accounts for 78% (83% at 31 March 2014) for the total amount receivable and for Lothian Buses Pension Fund the percentage for Switzerland is 87% (96% at 31 March 2014). 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.

2.12 The Swiss claims are discussed in more detail later on in this report.

Scottish Homes Pension Fund

2.13 The Scottish Homes Pension Fund is mainly invested in pooled funds, so there is no requirement to recover income tax as this is organised by the pooled fund manager.

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 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 2015);
- Review the withholding tax reclaims that have already been processed by NT and assess their timeliness.

Findings – WHT Rates Applied

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. These are summarised in the Appendix to this report, including responses from NT to the points raised.

Findings – WHT Claims

3.4 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.

3.5 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.

3.6 KPMG have again highlighted delay in dealing with the Swiss claims which accounted for 78% (£3,078k) of the value of Lothian Pension Fund claims and 87% (£415k) of the value of Lothian Buses Pension Fund claims as at 31 March 2015. The position for each year's reclaim can be summarised as follows, more details can be Appendix to this report :

Year	**Lothian Pension Fund Amt at 31/3/15** **£**	**Lothian Buses Pension Fund Amt at 31/3/15** **£**	**Comment**
2011	79k	-	Claim is responsibility of the custodian at the time dividends were received. Citibank have confirmed that the claim is still active and should be paid in due course.
2012	553k	114k	2012 claims were originally sent to the Swiss tax authority on 25 October 2013. After various queries raised by the Swiss tax authority they issued a formal rejection notice in July 2015, which meant that NT needed to resubmit the forms. Resubmission coincided with new procedures and delays caused by the claim certification required from HMRC. This should be completed in the next few weeks. Following which the Swiss tax authority should pay the claim within 6 to 8 weeks.
2013	812k	108k	This year's claim was certified by HMRC before the change of procedure and was not rejected by the Swiss. The claims for both Lothian Pension Fund and Lothian Buses Pension Fund were paid in September 2015.
2014	992k	120k	Claims have not yet been submitted by NT due to the HMRC certification issue mentioned above. However the certification issue is now resolved and NT are due to submit these claims in the next two weeks (from 6 November 2015).
2015	642k	73k	Claim cannot be made until the end of the calendar year.
Total	3,078k	415k	

3.7 In summary, despite the delays caused by HMRC and the Swiss Tax Authorities, the claim for 2013 was paid in September 2015 and this should set a precedence for the other claims to be paid in due course.

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 2014/15 on Lothian Pension Fund was £2,062k (£1,751k 2013/14); claims paid were £656k (£1,063k 2013/14), leaving a balance to be recovered of £3,937k at 31 March 2015 (£2,531k at 31 March 2014). For Lothian Buses Pension Fund, recoverable tax accrued during 2014/15 was £190k (£169k 2013/14); claims paid were £34k (£135k 2013/14), with the balance of £476k at 31 March 2015 (£320k at 31 March 2014).

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 Pension Board, 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
Single Outcome Agreement	
Appendices	Appendix 1 - Summary of the findings of the withholding tax benchmarking report

Pensions Audit Sub Committee **Appendix 1**

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 11 dividends have been subjected to WHT at rates from 9.49% to 15%. 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$37,224 (£17,394). We recommend that you raise this with your custodian.	NT comment: Lothian Pension Fund had an Australian Ruling in place for superannuation fund exemption under domestic law which expired June 2015. The exemption granted covered withholding tax on interest and dividends income only. This would not cover property income distributions where withholding tax can be applied. The renewal of the Private Ruling is currently pending, and Lothian can obtain tax relief from the point of the expired private ruling to when the new one is issued by way of reclaim. LPF comment: As pointed out by NT, some of the dividends were from a property investment company. NT has confirmed that they will make and reclaims necessary pending the granting of the Private Ruling.
Belgium WHT Rate	LPF should be eligible for a 0% rate of WHT on Belgian source dividends. 6 dividends have been taxed at a rate of 25% which is the standard domestic rate of WHT. It is unclear if a reclaim has been made in respect of these dividends. The potential reclaim available is €77,568 (£55,406). We recommend that you raise this with your custodian.	NT comment: Lothian Pension Fund currently receives relief at source in Belgium following submission of the Annex 26 form in February 2015. Prior to the documentation being in place tax was withheld on dividend pay date. Northern Trust would pursue reclaims where Relief at Source was not obtained. Also certain paying agents within the market are ‘black listed’. In this case, the sub custodian will process the dividend as a quick reclaim rather than applying relief at source.
Denmark WHT Rate	Under the Denmark UK Double Tax Treaty, a UK resident pension fund should be entitled to a reduced WHT rate of 15%. NT has applied WHT at rates of either 0% or 27%. The 27% rate is the standard domestic rate and we would expect reclaims to be made by NT and it appears that this	NT comment: Denmark is a reclaim market. Tax is withheld on pay date at 27% and Northern Trust will apply for a reclaim under tax treaty to reduce the rate to 15%. It is possible for certain dividends to pay

Country	Findings	Conclusions as at Date of Report to Pensions Audit Sub-Committee
	has been the case. It is unclear if the income amounts which appear to have been paid gross relate to previous reclaims. It is recommended that you confirm this with your custodian.	gross.
France WHT Rate	The dividend income from France has generally suffered 0%, 15% or 30%. Even across individual dividends there appear to be different rates applied. The correct rate for a UK resident pension fund is 15%. The differences may have arisen as both relief at source and reclaims are available in France and reclaims may be being shown as gross income. There are 167 income events which total over €5 million, therefore, this matter should be investigated with the custodian as soon as possible.	NT comment: NT would pursue a reduced withholding tax rate in France to 15%. The method to obtain the reduced rate would be either at source or via reclaim. Relief at source can be obtained on an annual basis with the submission of the Form 5000, certified by HMRC. This was in place in 2014. However in 2015 this was not obtained until June. This was due to a change in procedure at HMRC which resulted in delays in the certification process. Any prior withholding at 30% will be pursed via reclaim.
Germany WHT Rate	As with France, the data provided shows income paid either gross or at the standard rate of 26.375%. As Germany is a reclaim market, this may be that reclaims have been shown as gross income. We are aware that NT are making reclaims in Germany down to the correct treaty rate of 10% so this may not be an issue but we recommend that you discuss this with your custodian.	NT comment: Lothian Pension Fund can obtain a reduced rate in Germany to 10% withholding tax which can only be received via reclaim. On pay date the dividends would be received less 26.375% withholding tax. A reclaim is then accrued to obtain the remaining 16.375%.
Israel WHT Rate	The standard domestic rate of WHT in Israel is 25%. NT appears to be applying the rate under the Israel UK Double Tax Treaty of 15% to the income from the Teva Pharmaceutical ADRs. In our opinion, this reduced rate should not be available to a UK resident pension fund as the Treaty contains a “subject to tax” clause which LPF is unlikely to satisfy. We recommend that you discuss this with NT to understand the basis on which they are making the claim.	NT comment: These are related to ADR dividends which were received with the maximum tax rate applied. This is based on an allocation from DTC who specified the rate as 15%.
Italy WHT Rate	Italian source dividends should be taxed at a preferential domestic rate of 11% when paid to a UK resident pension fund. Italian income is being taxed at a variety of rates including 4 out of the 26 dividends being taxed at 11%. Given the variety of rates suffered and the difficulty in obtaining reclaims in Italy, we recommend that you raise this with your custodian.	NT comment: Lothian Pension Fund can obtain a reduced rate to 11% WHT. This is dependent upon receipt of a specifically worded Certificate of Residency from HMRC. This has been received for Lothian. For current year reclaims, it is common for divided to pay at the statutory rate of 26%. The dividend will then be adjusted to the favorable

Country	Findings	Conclusions as at Date of Report to Pensions Audit Sub-Committee
		rate up four months after pay date.
Korea WHT Rate	Two Korean dividends have suffered WHT at the standard domestic rate of 22%. LPF is entitled to a reduced rate of 15% under the Korean / UK Treaty. The potential leakage in this case is approximately US$ 1,878 (£1,219).	NT comment: A reduced rate of 15% can be obtained in Korea for Lothian Pension Fund. On non domestically held Korea securities (GDRs/ADRs) it is not possible to obtain relief at source.
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$10,380 (£6,740). We recommend that you raise this with your custodian, however as these amounts relate to ADRs it may be difficult to recover this tax.	NT comment: Lothian Pension Fund would receive dividend at the statutory rate of 30%. Although there is a potential reduced rate under tax treaty, a local tax advisor is required in order to obtain treaty benefits. NT is not able to offer this service in the Philippines. LPF comment: We have looked into the possibility of appointing a local tax adviser but this was not cost effective with the current low level of dividend income.
Poland WHT Rate	One dividend in Poland has suffered the standard domestic rate of 19%. The potential tax leakage is PLN 8,394 (£1,410), therefore we recommend that you raise this with your custodian.	NT comment: Under Polish domestic law it is possible to obtain exemption which Lothian currently receives. The exemption was obtained following the submission of market documentation. Withholding tax received prior to exemption being in place can be reclaimed by Northern Trust. One further document has been identified as required, which is a Declaration. We will send this out to you for completion shortly, once generated.
Russia WHT Rate	LPF has received most dividends at the correct WHT rate of 15%, however 5 were paid at 10%. This reduced rate is provided for under the Russia/UK Treaty, however, as the Treaty contains a subject to tax clause LPF should not be entitled to this rate. In addition, several dividends appear to have been paid gross. We recommend that we raise this with your custodian.	NT comment: The withholding relates to Russia ADRs. Treaty rates are applied based on residency disclosure of underlying holders which was stated at 10%.
Sweden WHT Rate	Swedish dividends should suffer WHT at a rate of 5%. It appears that a number of the dividends have been paid gross. The potential under withholding is	NT comment: The reduced rate payments in questions were

Country	Findings	Conclusions as at Date of Report to Pensions Audit Sub-Committee
	SEK 83,022 (£6,303), therefore we recommend that you discuss this with your custodian.	related to manufactured income payments for shares on loan. The income will be received inclusive of any potential reclaim entitlement which is why there had been only 5% WHT deduced.
Switzerland Reclaims	Numerous Swiss reclaims have been outstanding for longer than the expected timeframe. We are aware that Switzerland only allows 1 reclaim 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.	NT comment: 2012 claims were originally sent to the Swiss tax authority on 25th October 2013. In late 2013 the Swiss tax authority issued a letter requesting further information to support the reclaims. This request was part of a wider trend whereby the Swiss tax authority sought further information for reclaims on behalf of UK pension funds. Northern Trust provided the data required but received a second letter with additional questions. Northern Trust submitted a response for the second letter. This was not received by the Swiss tax authority within the desired timeframe. In July 2015 the Swiss tax authority provided a formal rejection notice which meant that Northern needed to recomplete the forms for the 2012 claims. Northern complied the 2012 reclaims again and sent them to the HMRC for certification as per standard process. Further delays were experienced in the certification of the documents from the HMRC. At the start of 2015 HMRC introduced a new procedure to obtain certification on reclaims. The new procedure allowed for the certification of 2015 reclaims. However it created a market wide issue as a process had yet to be established by HMRC to allow for certification of reclaim forms prior to 2015. This was an industry wide issue effecting all UK pension funds. Through the British Bankers Association, Northern have been lobbying the HRMC and a solution has now been agreed to obtain the required historic certification. We anticipate that Lothians certified forms will be with us in the coming weeks so that the 2012 claims can be submitted to the Swiss tax authority. Once submitted we expect the reclaims to be settled within 6/8 weeks. During the period of initial submission to

Country	Findings	Conclusions as at Date of Report to Pensions Audit Sub-Committee
		now the claims have been protected against statue. 2013 claims were not formally rejected, and answers to subsequent questions were provided without new forms needed. The original 2013 submission was certified, therefore was not delayed due the HMRC issue mentioned above. We have since received the funds. 2014 claims have not yet been submitted due to the HMRC certification issue mentioned above. However the certification issue is now resolved and Northern are due to submit these claims in the next two weeks.
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 121,614 (£2,434).	NT comment: Although a reduced tax rate may be possible under double tax treaty, Northern Trust is unable to support the reclaim process. This is due to the requirement of a local agent in the market. Dividend in the market will be received with 20% WHT.