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	

•EDINBVRGH•
THE CITY OF EDINBURGH COUNCIL

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

E-mail: magnus.aitken@edinburgh.gov.uk | Tel: 0131 469 3143

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

EDINBVRGH
THE CITY OF EDINBURGH COUNCIL

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. Pension Contributions – 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. Purchasing - 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. Sales Invoicing - 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

CG1501

EDINBVRGH THE CITY OF EDINBURGH COUNCIL

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.