

# Notice of meeting and agenda

## **Pensions Audit Sub Committee**

**14.00, Monday 5 December 2016**

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**

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- 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**

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- 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**

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- 3.1 None

## **4. Minute**

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- 4.1 Minutes of the meeting of 27 September 2016 – submitted for approval as a correct record (circulated)

## **5. Reports**

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- 5.1 Agenda Planning – report by the Acting Executive Director of Resources (circulated)
- 5.2 EU Tax Claims & Income Recovery – report by the Acting Executive Director of Resources (circulated)
- 5.3 Global Custody Services Performance – report by the Acting Executive Director of Resources (circulated)
- 5.4 Investment Income Review Cross Border Withholding Tax – report by the Acting Executive Director of Resources (circulated)
- 5.5 Lothian Pension Fund – Internal Audit Update 2016/17 – report by the Acting Executive Director of Resources (circulated)

## **6. Motions**

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- 6.1 If any

### **Kirsty-Louise Campbell**

Interim Head of Strategy and Insight

### **Committee Members**

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Councillors Rose (Convener), Bill Cook and Orr.

### **Information about the Pensions Committee**

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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**

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If you have any questions about the agenda or meeting arrangements, please contact Stuart McLean, Committee Services, City of Edinburgh Council, City Chambers, High Street, Edinburgh EH1 1YJ, Tel 0131 529 4106, e-mail [stuart.mclean@edinburgh.gov.uk](mailto:stuart.mclean@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](http://www.edinburgh.gov.uk/cpol).

## Pensions Audit Sub-Committee of the Pensions Committee

**14.00, Tuesday 27 September 2016**

### Present

Councillors Rose (Convener), Bill Cook and Orr.

### Pensions Board Members Present:

Jim Anderson and Darren May

## 1. Minute

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### Decision

To approve the minute of the Pensions Audit Sub-Committee of the Pensions Committee of 22 June 2016 as a correct record.

## 2. Agenda Planning

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An overview of potential reports for future Pensions Committee and Pensions Audit Sub-Committee meetings for December 2016 and March 2017 were outlined.

### Decision

To note the agenda planning document.

(Reference – report by the Acting Executive Director of Resources, submitted.)

## 3. Audited Annual Report 2016 of the Lothian Pension Fund, Lothian Buses Pension Fund and Scottish Homes Pension Fund Annual Report, including Annual Report by Audit Scotland

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Audit Scotland had undertaken its statutory audit of the Annual Report 2016 of the three pension funds administered by the City of Edinburgh Council.

The Accounts showed that the Lothian Pension Fund valuation had increased over the year by 6.4% to £5,434 million and Lothian Buses Pension Fund had increased by

2.2% to £394.4 million. The Scottish Homes Pension Fund had decreased by 2.9% to £150.3 million.

A representative from Audit Scotland was present for this item.

### **Decision**

- 1) To note the “Audit Scotland 2015/16 annual audit report to Members and the Controller of Audit” attached at Appendix 1 to the report by the Acting Executive Director of Resources.
- 2) To recommend to the Pensions Committee to communicate to the Chartered Institute of Public Finance and Accountancy (CIPFA), Audit Scotland and the Scheme Advisory Board (of the Local Government Pension Scheme in Scotland), the Committee’s concerns with the relaxation of the principle of full cost transparency of investment management fees, as explicit in CIPFA’s revised guidance “Accounting for Local Government Pension Scheme Management Costs”, dated March 2016.

(Reference – report by the Acting Executive Director of Resources, submitted.)

## **4. Lothian Pension Fund – Internal Audit Update 2016/17**

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A summary was provided of Internal Audit Activity during the period 1 April 2016 to 31 August 2016.

### **Decision**

- 1) To note the Internal Audit activity undertaken during the period 1 April to 31 August 2016.
- 2) To note the matters arising from the Internal Audit review undertaken during the period 1 April to 31 August 2016.
- 3) To note the status of management actions from audits undertaken in 2015/16.

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

## **5. Annual Report on LPFE Limited and LPFI Limited**

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In support of the administration of the pension funds that it administered, an update on the business and operation of LPFE Limited and LPFI Limited was provided.

### **Decision**

- 1) To note that the remit of the Pensions Audit Sub-Committee had been amended by Council to include scrutiny of the Council companies associated with the Pension Fund.

- 2) To note the LPFE Limited annual accounts and the updates on LPFE and LPFI provided in the report by the Acting Executive Director of Resources.
- 3) To ask that the following be included within the next annual update:
  - Salaries associated with LPFE.
  - The performance of the LPFE Board.
- 4) To note that details of the LPFI Non-Executive director would be circulated to the Committee and Pension Board once the appointment was confirmed.

(Reference – report by the Acting Executive Director of Resources, submitted.)

## **6. Pensions Administration Data Quality**

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

### **Decision**

To note the report by the Acting Executive Director of Resources.

(Reference – report by the Acting Executive Director of Resources, submitted.)

## **7. Fraud Prevention**

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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 by the Acting Executive Director of Resource.

(Reference – report by the Acting Executive Director of Resources, submitted.)

## **8. Irrecoverable Overpayment of Pensions – Decisions Made Under Delegated Authority**

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An update was provided on pension overpayments during the period 1 September 2015 to 31 August 2016 which had been deemed irrecoverable by the Acting Executive Director of Resources, in accordance with the Council's Scheme of Delegation to Officers.

### **Decision**

To note that the total value of pension overpayments written off between 1 September 2015 and 31 August 2016 was £9,671.73.

(Reference – report by the Acting Executive Director of Resources, submitted.)

## 9. Risk Management Summary

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A summary was provided of the Lothian Pension 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 Acting Executive Director of Resources, submitted.)

# Pensions Audit Sub Committee

2.00 p.m., Monday, 5 December 2016

## Agenda Planning

Item number	5.1
Report number	
Executive/routine	
Wards	All

### Executive summary

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

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

### Links

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Coalition pledges	
Council outcomes	<a href="#">CO26</a>
Single Outcome Agreement	



## Agenda Planning

### Recommendations

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Committee is requested to:

- 1.1 Invite the Pension Board to raise any relevant matters or concerns which the Committee should consider; and
- 1.2 Note the agenda planning document.

### Background

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- 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

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

#### March 2017

##### **Pensions Committee**

- Considerations and matters to be raised by the Pension Board regarding any items on the agenda
- Audit plans and reports (internal and external will be drafted in consultation with the Convener of the Audit-Sub Committee).
- Governance Update
- Assurance of the provision of non-audit services to LPFE Limited
- Investment Controls and Compliance (originally scheduled to be presented at the December 2016 Audit Sub Committee meeting this paper was delayed due to key information being unavailable)
- Employers Participating in Lothian Pension Fund
- Service Plan Update
- Budget for 2017/18
- Risk management summary

## June 2017

<b>Pensions Committee</b>	<b>Audit Sub Committee</b>
<ul style="list-style-type: none"><li>• Referrals / recommendations from Pensions Audit-Sub Committee</li><li>• Considerations and matters to be raised by the Pension Board regarding any items on the agenda</li><li>• LPF Annual Report (&amp; Accounts) Unaudited</li><li>• Statement of Investment Principles</li><li>• Investment Strategy Panel Activity</li><li>• Annual Investment Updates – Lothian Pension Fund, Lothian Buses Pension Fund and Scottish Homes Pension Fund</li><li>• Risk management summary</li></ul>	<ul style="list-style-type: none"><li>• LPF Annual Report (&amp; Accounts) Unaudited</li><li>• Risk management summary</li></ul>

### Future Pensions Committee and Audit Sub Committee dates:

<b>Pensions Committee</b>	<b>Pensions Audit Sub Committee</b>
<ul style="list-style-type: none"><li>• Wednesday 20 March 2017, 2pm Dunedin Room, City Chambers</li><li>• Wednesday 28 June 2017, 2pm Dunedin Room, City Chambers</li></ul>	<ul style="list-style-type: none"><li>• Tuesday 27 June 2017, 2pm Dunedin Room, City Chambers</li></ul>

## Measures of success

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- 4.1 The Committee and Pension Board have greater clarity regarding the content of the Committee Cycle.

## Financial impact

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- 5.1 None.

## Risk, policy, compliance and governance impact

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- 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

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

## Sustainability impact

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

## Consultation and engagement

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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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None.

## Hugh Dunn

Acting Executive Director of Resources

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## Links

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### 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 – Scheme of Committee Papers

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)	N/A	March
	Service Plan (every 2 years)	N/A	
	Budget	N/A	March
	Governance Update	N/A	March
	Audit Sub-Committee Appointments	N/A	March
	LPF Annual Report (& Accounts) Unaudited	LPF Annual Report & Accounts (Unaudited)	June
	Statement of Investment Principles	N/A	June
	Investment Strategy Panel Activity	N/A	June
	Annual Investment Updates - Lothian Pension Fund, Lothian Buses Pension Fund and Scottish Homes Pension Fund.	N/A	June
	LPF Annual Report & Accounts Audited	LPF Annual Report & Accounts (Audited)	September
	ISA 260 Audit Report	ISA 260 Audit Report	September
	N/A	Pensions Data Quality	September
	N/A	Delegated authorities: Write offs	September
	N/A	Fraud Prevention	September
	Annual Report by External Auditor	Annual Report by External Auditor	December (or September if available)
	Benchmarking	N/A	December
	N/A	EU Tax Claims & Income Recovery	December
N/A	Investment Income Review-Cross-Border withholding tax	December	
Stewardship	N/A	December	
N/A	Investment Controls & Compliance	December	
N/A	Global Custody Services Performance	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
	Considerations and matters to be raised by the Pension Board regarding any items on the agenda	N/A	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.)	N/A	
	N/A	Internal Audit Reports	
	Regulatory Update	N/A	
	Investment Strategy Reviews (at least every 3 years)	N/A	
	N/A	Risk management (in depth review)	

# Pensions Audit Sub Committee

2.00 p.m., Monday, 5 December 2016

## EU Tax Claims & Income Recovery

Item number	5.2
Report number	
Executive/routine	
Wards	All

### Executive summary

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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, no additional claims have been received and the amount recovered to date remains at £1,370.1k. Progress on the remaining claims is discussed in detail within the report.

### Links

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Coalition pledges	
Council outcomes	<a href="#">CO26</a>
Single Outcome Agreement	

## EU Tax Claims & Income Recovery

### Recommendations

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Committee is requested to:

- 1.1 Invite 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 6 December 2016.

### Background

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- 2.1 EU tax claims relate to the recovery of tax deducted from dividend payments prior to receipt or payable tax credits thereon. 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 in a way that is likely to hinder the free movement of capital.
- 2.2 The claims can be divided into three main types – Manninen / Foreign Income Dividends (FIDS), 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

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#### **Claims - Manninen / Foreign Income Dividends (FIDS)**

- 3.1 These claims are against the UK tax authorities. The FIDs claim is based on the UK providing for the repayment of tax credits on UK dividends but not on Foreign Income Dividends ("FIDs") paid by UK companies. The Manninen claim is based upon the non-availability of payable tax credits in relation to foreign dividends.
- 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 statutory claims on behalf of UK pension funds to claim a repayment of tax credits on FIDs and overseas dividend income in respect of periods

1990/91 to 1997/98. Pension funds have also pursued parallel claims in the High Court.

- 3.4 The claims are for tax credits and are based on the rate of advance corporation tax in place in respect of the overseas dividends. 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 by way of a test case brought with the BT Pension Scheme as the test claimant.
- 3.6 A 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: <ul style="list-style-type: none"> <li>• Withholding of tax credits on foreign income dividends and overseas dividends (Manninen) was a breach of EU law – the substantive issues.</li> <li>• All but one of the 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.</li> </ul>
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.
April 2013	Upper Tribunal refuses HMRC's request for leave to appeal on the substantive issue and claimants' request on the out of time issue.
June 2013	Court of Appeal approves direct requests to appeal from HMRC and claimants.
November 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).
January 2014	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 issues.
July 2015	The Court of Appeal handed down its judgement: <ol style="list-style-type: none"> <li>1. The original decision on the out of time issue is upheld.</li> <li>2. On the substantive FIDs issue the Court has decided to refer this to the CJEU.</li> <li>3. The Court did not determine the substantive Manninen issue because it was found not to be relevant as the claims were out of time.</li> </ol> <p>On the FIDs substantive issue the parties agreed the specific questions that will be referred to the CJEU.</p>
August 2015	On the out of time issue an application for permission to appeal was submitted to the Supreme Court directly.
January 2016	The Supreme Court refuses to grant permission to appeal on out of time issue.  CJEU acknowledge start of legal process on the substantive issue. Hearing should take place late in 2016 with the judgement likely to be issued within six months afterwards.
October 2016	CJEU hearing was held on 9 November 2016 with the Opinion of the Advocate General likely to follow about three months later.

- 3.7 The above wording on progress with this claim has been reviewed by Pinsent Masons.
- 3.8 Fees incurred to date, by Lothian Pension Fund, on these claims amount to £63.4k (£58.2k as at the last update to Committee in December 2015). 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

- 3.9 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.
- 3.10 The Pensions Committee of October 2007 approved making claims under the principle established in the Fokus Bank case. Claims currently estimated at around £3.7m have been made. Progress on the claims is summarised in the table below.

Country	Claim Period From / To	Estimated Amount Claimed	Amount Received	Notes
<b>Completed Claims</b>				
Austria	2006 2010	£83.0k	£83.0k	Claim paid in September 2012.
Netherlands	2003 2006	£440.0k	£440.0k	Claim paid in 2009.
Norway	2004 2010	£278.9k	£278.9k	All claims paid - final instalment received in February 2013 (£73k)
Spain	2004 2009	£568.2k	£568.2k	All claims paid - final instalment received in March 2015 (£102k)
<b>Active Claims</b>				
France	2005 2009	£701.4k [€776.7k]	-	<p>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.</p> <p>In February 2016 KPMG submitted a comparability analysis demonstrating that Lothian Pension Fund is in a similar situation to the test claimant. For efficiency purposes our claim is being included in a batch with similar claimants. This has delayed the filing of the documentation with the French Tax Authorities. There is the chance that we could see payment of the claim during 2017.</p>

Country	Claim Period From / To	Estimated Amount Claimed	Amount Received	Notes
Germany	2003 2010	£971.8k [€1,076.0k]	-	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.
	2011 2014	£122.3k [€135.5k]		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 continuing delays in KPMG appointing a test claimant so that the question of repayment can be decided in the German Courts. The delay is due to German pension funds not being all treated as wholly tax exempt in Germany –resulting in difficulties in making comparisons with UK pension funds. KPMG continues to look for effective ways of progressing the claims of UK pension funds.
Italy	2004 2010	£542.3k [€600.5k]	-	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. KPMG believe claimants prefer to concentrate efforts on France and Germany before considering Italy.
<b>TOTAL</b>		<b>£3,707.9k</b>	<b>£1,370.1k</b>	

3.11 Exchange rate movements have had the effect of increasing the value of the unpaid claims since last year's report. Increasing the estimated total amount claimed from £3,207.7k to £3,707.9k.

3.12 Fees incurred to date on these claims amount to £389.7k (£369.4k as at the meeting of December 2015). Costs are higher for the Fokus Bank type claims because of the need to file claims separately in individual EU countries.

#### **Claims – Manufactured Dividends (MODs)**

3.13 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 manufactured overseas dividends suffered a UK withholding tax.

- 3.14 Note that manufactured dividends are dividends created when a security is out on loan at the time the company pays a dividend.
- 3.15 Claims in respect of manufactured dividends totalling £4,870.6k have been lodged with HMRC on behalf of Lothian Pension Fund
- 3.16 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 were in correspondence with HMRC through the course of 2014 and have 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 to be handed down at a later date.
July 2016	The FTT concluded that there was a movement of capital, but that the MODs rules applied by HMRC did not amount to a restriction on the movement of capital.
August 2016	The FTT granted the test claimant permission to appeal its decision to the Upper Tribunal.
October 2016	The Upper Tribunal stage commenced.

- 3.17 The above wording on progress with this claim has been reviewed by Pinsent Masons.
- 3.18 Fees incurred to date on these claims amount to £146.3k (£116.3k as at the meeting of December 2015). Potential subsequent referrals are estimated to cost £20k for each legal stage.

**Claims – Master Limited Partnerships**

- 3.19 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.
- 3.20 Following a competitive tender in the summer of 2015, a KPMG was appointed to make a tax claim in the USA. The value of the claim for the year ended 31

December 2014 was estimated to be around \$576,000. However, after detailed research by KPMG, it has been discovered that the WHT deducted from Publicly Traded Partnership Distributions is not recoverable by UK pension funds. As a result this claim cannot be progressed. The investigation work incurred a fee of £4k, given the tax loss to Lothian Pension Fund; it was deemed appropriate to do sufficient research to definitively decide the matter. For investment reasons, Master Limited Partnerships are no longer used by Lothian Pension Fund.

## Measures of success

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

## Financial impact

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- 5.1 Tax claims totalling of £11.2m have now been lodged with the relevant tax authorities. Professional fees amounting to £599.4k 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 £770.7k. So irrespective of the outcome of the remaining claims Lothian Pension will have accrued a financial benefit. The financial position can be summarised as follows:

<b>Claim Type</b>	<b>Total Claims £'000</b>	<b>Claims Settled £'000</b>	<b>Claims Outstanding £'000</b>	<b>Costs to Date £'000</b>
Manninen	2,626.7	Nil	2,626.7	63.4
Fokus Bank	3,707.9	1,370.1	2,337.8	389.7
Manufactured Dividends	4,870.6	Nil	4,870.6	146.3
	<b>11,205.2</b>	<b>1,370.1</b>	<b>9,835.1</b>	<b>599.4</b>

## Risk, policy, compliance and governance impact

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

## Equalities impact

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

## Sustainability impact

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

## Consultation and engagement

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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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None.

## Hugh Dunn

Acting Executive Director of Resources

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## Links

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### 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**

# Pensions Audit Sub Committee

2.00 p.m., Monday, 5 December 2016

## Global Custody Services Performance

<b>Item number</b>	5.3
<b>Report number</b>	
<b>Executive/routine</b>	
<b>Wards</b>	All

### Executive summary

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This report presents the Key Performance Indicator Report for the 12 months ended 30 September 2016 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.

During the year, the Fund exercised its option to extend its custody contract by three years to February 2020.

As discussed in the report, there has been deterioration in the timeliness of corporate action responses. On review of the data this deterioration was due to one of the Fund's external investment manager's therefore largely outside the control of Northern Trust. The investment manager is currently investigating the issue.

During the period there was also an improvement in the monthly valuation and financial reporting of the Fund.

The conclusion is that Northern Trust's services are currently meeting the needs of the three Pension Funds.

### Links

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**Coalition pledges**

**Council outcomes** [CO26](#)

**Single Outcome Agreement**

## Global Custody Services Performance

### Recommendations

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Committee is requested to:

- 1.1 Invite 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 6 December 2016.

### Background

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- 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:
  - Safe custody of investment assets
  - 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 2016. 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 annual reports, with the former being considered by the Investment Strategy Panel. 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 30/9/16	Green (Previous Report: Amber)
Comments	<p>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.</p> <p>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.</p> <p>A senior member of the custodian's reporting team took over our account during the year which saw an improvement in standards for the year end up to 30 September 2016, with only one occasion over the 14 day target sign off period. This delay in sign off was a result of a query submitted by the Funds' staff over the recording of a new financial instrument. Queries are regularly 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.</p>

### 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
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	<p>inclusion in the annual accounts.</p> <p>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.</p>
Performance Traffic Lights	<p>Green – Completed by business day 18</p> <p>Amber – Completed by business day 19</p> <p>Red – Completed by business day 20 or later</p>
Service Rating Over 12 Months to 30/9/16	Green (Previous Report: Amber)
Comments	<p>More time is allowed at the year end for the preparation of the additional information required for the annual accounts.</p> <p>The month end accounts are checked by the Fund for accuracy. Any delays in month end valuation reporting have a knock on effect in completion of the monthly financial reporting. As per above the Fund has seen an improvement in reporting over the period.</p>

#### Trade Settlement Statistics

Description of Indicator	<p>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.</p> <p>The indicator is the percentage of trades that have settled on time.</p>
Performance Traffic Lights	<p>Green – 94% or higher</p> <p>Amber – 92% to 94%</p> <p>Red – 91% or lower</p>
Service Rating Over 12 Months to 30/9/15	Green (Previous Report: Green 96.40%) 95.35%
Comments	<p>During the period there were a total of 6,271 trades of which 6,677 (96.40%) were settled on time. Of the 306 trades settled late, 230 were purchases and 76 were sales. This reflects the main reason for late settlement that Lothian</p>

	<p>Pension fund experiences – that the selling broker does not initially have sufficient shares to settle the purchase trade.</p> <p>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.</p> <p>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.</p>
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### Income Collection Statistics

Description of Indicator	<p>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.</p> <p>The indicator is the percentage of the number of income payments received on pay day.</p>
Performance Traffic Lights	<p>Green – 95% to 100%</p> <p>Amber – 90% to 95%</p> <p>Red – 90% or lower</p>
Service Rating Over 12 Months to 30/9/15	<p>Green (Previous Report: Green 98.65%) 99.40%</p>
Comments	<p>The performance indicator is based on the number of income collections rather than their value. During the period there were a total of 2,486 income collections, 2,471 (99.40%) of which were received on the correct pay day.</p> <p>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.</p> <p>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.</p>

## Corporate Actions

<p>Description of Indicator</p>	<p>Corporate actions are events announced by companies that give shareholders the opportunity to make a decision on two or more potential choices. For example:</p> <ul style="list-style-type: none"> <li>• Rights issue to buy additional shares</li> <li>• Dividend reinvestment in additional shares</li> <li>• Receive dividend in GBP, USD or EUR</li> </ul> <p>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.</p> <p>The indicator is the percentage of responses made by the client with the deadline date set by the company for a response.</p> <p>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.</p>
<p>Performance Traffic Lights</p>	<p>Green – 100%</p> <p>Amber – 95% to 99%</p> <p>Red – 94% or lower</p>
<p>Service Rating Over 12 Months to 30/9/15</p>	<p>Red</p> <p>94.32% (Previous Report: Amber 96.24%)</p>
<p>Comments</p>	<p>During the period there were 563 corporate actions, 531 (94.32%) of which are recorded as having been responded to within the time limit.</p> <p>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.</p> <p>Of the 32 late items 22 related to one of the Fund's external managers. The investment manager has investigated the issue and indicated that inadequacies in their corporate</p>

	<p>action system led to the late election of corporate actions. The system has since been updated which has resulted in an improvement in response times. The Fund will continue to monitor the situation.</p> <p>On assessment, the late corporate actions did not represent the potential for financial loss to the Fund.</p>
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## Measures of success

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

## Financial impact

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- 5.1 The budget set for the provision of custody services for 2016/17 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 winner of the last exercise and the initial contract was set for five years ending in February 2017, with the option to extend for a further three years. The Fund has recently exercised this option to extend the contract to February 2020. Northern Trust has a strong presence in the LGPS market, currently providing custody services to 40% of the UK's LGPS. 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

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

## Equalities impact

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

## Sustainability impact

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8.1 There are no sustainability impacts arising from this report.

## Consultation and engagement

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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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None

### Hugh Dunn

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## Links

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<b>Coalition pledges</b>	
<b>Council outcomes</b>	CO26 - The Council engages with stakeholders and works in partnerships to improve services and deliver agreed objectives
<b>Single Outcome Agreement</b>	
<b>Appendices</b>	None

# Pensions Audit Sub Committee

2.00 p.m., Monday, 5 December 2016

## Investment Income Review Cross Border Withholding Tax

Item number	5.4
Report number	
Executive/routine	
Wards	All

### Executive summary

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This report provides information on a benchmarking study prepared by E&Y 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 E&Y shows that Northern Trust is generally applying the correct withholding tax rates on investment income. Recovery claims are being processed and reclaims received but E&Y feel that the time taken seems to be longer than the market standard for refunds. Claims due at 31 March 2016 are at the same levels as the previous year, meaning that the claims paid are balanced by new claims made.

### Links

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Coalition pledges

Council outcomes

[CO26](#)

Single Outcome Agreement

## Investment Income Review Cross Border Withholding Tax

### Recommendations

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Committee is requested to:

- 1.1 Invite 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 6 December 2016.

### Background

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#### **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 2015/16 financial year the Pension Funds earned income from companies in 45 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 2015/16 and 2014/15 financial years for both Lothian Pension Fund and Lothian Buses Pension Fund.

<b>Lothian Pension Fund</b>	<b>2015/16</b> £	<b>2014/15</b> £
Brought Forward 1 April	3,937,409.41	2,531,042.23
Recoverable tax accrued during year	2,113,859.80	2,062,513.96
Claims paid during year	(2,052,596.20)	(656,146.78)
Carried Forward 31 March	3,998,673.01	3,937,409.41

<b>Lothian Buses Pension Fund</b>	<b>2015/16</b> £	<b>2014/15</b> £
Brought Forward 1 April	476,181.59	320,259.30
Recoverable tax accrued during year	202,692.33	189,959.71
Claims paid during year	(244,895.23)	(34,037.42)
Carried Forward 31 March	433,978.69	476,181.59

- 2.9 For both funds the balance of recoverable tax at 31 March 2016 is broadly comparable to the balances at the preceding year. This is due to the amount of additional tax accruing during the twelve months being approximately the same as the claims paid. Claims paid during 2015/16 are considerably higher than 2014/15.
- 2.10 The year end recoverable tax balances at 31 March 2016 and 31 March 2015, broken-down by country for both Lothian Pension Fund and Lothian Buses Pension Fund are provided in the tables below.

<b>Lothian Pension Fund</b>	<b>Reclaim Amount 31/3/16 £</b>	<b>Number of Dividends 31/3/16</b>	<b>Reclaim Amount 31/3/15 £</b>	<b>Number of Dividends 31/3/15</b>
Austria	38,001.16	16	34,795.27	31
Belgium	33.37	1	30.45	1
Canada	4,526.36	2	-	-
Denmark	8,280.04	5	1,041.69	3
France	37,744.04	25	6,279.24	4
Germany	138,136.59	21	17,720.39	10
Israel	12,598.08	3	1,613.34	1
Japan	-	-	-	-
Netherlands	178,050.13	22	55,868.52	9
Norway	445,730.33	26	240,655.91	12
Poland	14,250.66	2	13,544.28	2
Russian Federation	-	-	23,301.70	1
South Africa	-	-	532.56	1
Spain	15,090.80	4	245,452.03	67
Sweden	326.30	1	-	-
Switzerland	2,918,336.47	46	3,078,224.96	77
United Kingdom	187,568.68	11	216,945.77	17
United States	-	-	1,403.30	2
<b>Grand Total</b>	<b>3,998,673.01</b>	<b>185</b>	<b>3,937,409.41</b>	<b>238</b>

<b>Lothian Buses Pension Fund</b>	<b>Reclaim Amount 31/3/16 £</b>	<b>Number of Dividends 31/3/16</b>	<b>Reclaim Amount 31/3/15 £</b>	<b>Number of Dividends 31/3/15</b>
Denmark	2,414.66	3	91.72	1
France	7,190.49	2	-	-
Germany	19,568.27	4	4,302.45	2
Italy	885.75	1	-	-
Japan	-	-	4,343.42	1
Netherlands	14,499.30	5	5,051.26	2
Norway	61,318.63	14	34,592.56	7
Spain	2,396.08	1	2,186.45	1
Switzerland	305,725.80	15	414,841.70	18
United Kingdom	19,979.71	5	10,772.03	3
<b>Grand Total</b>	<b>433,978.69</b>	<b>50</b>	<b>476,181.59</b>	<b>35</b>

2.11 For Lothian Pension Fund, Switzerland accounts for 73% (78% at 31 March 2015) for the total amount receivable and for Lothian Buses Pension Fund the percentage for Switzerland is 70% (87% at 31 March 2015). 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, German, Dutch and Norwegian claims are discussed in more detail later 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**

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### **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, Ernst & Young (E&Y) has been commissioned to prepare a benchmarking report. E&Y's remit was:
- Review the withholding tax rates applied by NT and verify these with a database of rates prepared by E&Y;
  - 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 2016);
  - Review the withholding tax reclaims that have 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 number of opportunities and issues. These are summarised in the Appendix to this report. NT has responded to the points raised and their comments are included in the Appendix. As at the date of preparing this report we are working to clarify some remaining points on Denmark, France and Germany. A further update will be provided at the Sub Committee meeting.

### **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 of time to process the claim and pay the refund. 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 E&Y report identified examples of NT's claims processing being slower than the market standard for such work. However, with the exception of the Swiss,

German, Dutch and Norwegian claims the amounts involved were relatively low. We will continue to work with NT to ensure that our claims are processed as quickly as possible.

- 3.6 Swiss claims accounted for 73% (£2,918k) of the value of Lothian Pension Fund claims and 70% (£306k) of the value of Lothian Buses Pension Fund claims as at 31 March 2016. The position for each year's reclaim compared with the position at 31 March 2015 can be summarised as follows:

Year	Lothian Pension Fund	Lothian Pension Fund	Lothian Buses Pension Fund	Lothian Buses Pension Fund	Comment
	31/3/16 £	31/3/15 £	31/3/16 £	31/3/15 £	
2011	-	79k		-	Claim paid in 2015/16
2012	-	553k		114k	Claim paid in 2015/16
2013	-	812k		108k	Claim paid in 2015/16
2014	1,040k	992k	125k	120k	Claim paid in October 2016
2015	1,153k	642k	105k	73k	2015 claims are expected to be paid during the second quarter of 2017
2016	725k	-	76k	-	Claim cannot be made until the end of the calendar year
<b>Total</b>	<b>2,918k</b>	<b>3,078k</b>	<b>306k</b>	<b>415k</b>	

- 3.7 In summary, the claims for 2011, 2012 and 2013 were paid in financial year 2015/2016 and the claims for 2014 were paid in October 2016. This represents a considerable improvement compared to the situation a few years ago.

- 3.8 For Germany the position for the Lothian Pension Fund claims can be summarised as follows;

Year	Lothian Pension Fund	Lothian Pension Fund	Comment
	31/3/16 £	31/3/15 £	
2014	15k	17k	Due to changes in the certification process required by HMRC the claims for 2014 were not submitted to the German authorities until August 2016. They are expected to be paid during the second quarter of 2017.
2015	30k	-	Submitted to the German authorities in August 2016.
2016	93k	-	Increase in exposure to German market has increased the amount to claim. Claims currently under preparation.
<b>Total</b>	<b>138k</b>	<b>17k</b>	

3.9 For the Netherlands the position for the Lothian Pension Fund claims can be summarised as follows;

Year	Lothian Pension Fund	Lothian Pension Fund	Comment
	31/3/16 £	31/3/15 £	
2011	-	6k	Claim paid during 2015/16.
2013	5k	4k	Claim delayed due to discrepancy at sub custodian. Situation is being investigated.
2014	-	23k	Claim paid during 2015/16.
2015	145k	23k	Increase in exposure to Dutch market. Paid October 2016.
2016	28k	-	Claim submitted September 2016.
<b>Total</b>	<b>178k</b>	<b>56k</b>	

3.10 For Norway the position for the Lothian Pension Fund claims can be summarised as follows;

Year	Lothian Pension Fund	Lothian Pension Fund	Comment
	31/3/16 £	31/3/15 £	
2014	224k	223k	Similar to the German market, there was a delay in the HMRC certification which resulted in the extended timeframe. Additionally, there was a question raised by the Norwegian authorities in relation to the dividend voucher which NT provided, in February 2016. The pre-2016 reclaims are all pending with the Norwegian Tax Authorities.
2015	201k	18k	See above.
2016	21k	-	Claim cannot be made until end of calendar year.
<b>Total</b>	<b>446k</b>	<b>241k</b>	

## Measures of success

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- 4.1 Minimising exposure to tax on investment income.
- 4.2 Obtaining prompt recovery of reclaimable income tax deducted at source.

## Financial impact

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- 5.1 The recoverable tax accrued during 2015/16 on Lothian Pension Fund was £2,114k (£2,062k 2014/15); claims paid were £656k (£2,053k 2014/15), leaving a balance to be recovered of £3,999k at 31 March 2016 (£3,937k at 31 March 2015). For Lothian Buses Pension Fund, recoverable tax accrued during 2015/16 was £203k (£190k 2014/15); claims paid were £245k (£34k 2015/16), with the balance of £434k at 31 March 2016 (£476k at 31 March 2015).

## Risk, policy, compliance and governance impact

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

## Equalities impact

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

## Sustainability impact

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

## Consultation and engagement

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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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None.

## Hugh Dunn

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## Links

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### 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 – Summary of the findings of the withholding tax benchmarking report

## Summary of the Findings of the Withholding Tax Benchmarking Report

Country	Findings	Conclusions as at Date of Preparation of Report to Pensions Audit Sub-Committee
Austria	<p>While the statutory position is 27.5% withholding tax with a 12.5% reclaim allowed under the treaty, Austria does allow for UK pension funds to make full reclaims as a UK pension fund is similar to an Austrian pension fund, which is allowed an exemption.</p> <p>In most instances, the full reclaim appears to be made by Northern Trust and therefore Lothian receives the correct amount. For two dividend distributions however, Northern Trust is showing a 12.5% reclaim instead of a 27.5% reclaim. The amount involved is £16,867.</p>	<p>LPF comment:</p> <p>Query has been raised with NT.</p> <p>NT comment:</p> <p>Under double tax treaty the withholding tax rate can be reduced to 15%. There is also a potential to reclaim to the full exemption rate via reclaim under domestic law. UK pension funds must demonstrate equivalency to an Austrian pension fund. For Lothian NT accrued the full exemption rates for 2012-2015. Due to uncertainty around supporting documentation requirements, for 2016, NT changed the process to accrued at the treaty rate. Following successful repayment at the domestic law rate NT would accrue and process the additional reclaim amount.</p>
China	<p>Investments into Chinese entities may be Chinese-listed ("A shares") or foreign listed (e.g. Hong Kong listed H shares). As the dividends shown in the report are denominated in Hong Kong Dollars, we would expect these investments to be in H shares. Hong Kong does not impose withholding tax on dividends. As such, we would expect the further reclaims of £102,086 to be available. This may not be the case if the shares are not, in fact, H shares.</p>	<p>LPF comment:</p> <p>Query has been raised with NT.</p> <p>NT comment:</p> <p>Although Chinese shares can be H-shares, pursuant to Enterprise Income Tax Law in China, issuers may be required to withhold tax on dividend payments to non-resident shareholders. This can result in the withholding of 10% on H-shares.</p>
Denmark	<p>While the statutory position is 27% withholding tax with a 12% reclaim allowed under the treaty, Denmark does allow for UK pension funds to make full reclaims as a UK pension fund is similar to a Danish pension fund, which is allowed an exemption.</p> <p>In most instances, the full reclaim appears to be made by Northern Trust and therefore Lothian receives the correct amount. For five dividend</p>	<p>LPF comment:</p> <p>Query has been raised with NT.</p> <p>NT comment:</p> <p>NT would submit reclaims at the Double Tax Treaty rate. Income would be received with 27% WHT and a reclaim would be submitted to recover 12% WHT. There is no process in place</p>

Country	Findings	Conclusions as at Date of Preparation of Report to Pensions Audit Sub-Committee
	<p>distributions however, Northern Trust is showing a 12% reclaim instead of a 27% reclaim. The potential further reclaims amount to £20,647.</p>	<p>on obtain a further reclaim under domestic law.</p> <p>LPF comment:</p> <p>We are looking into the whether there is any merit in procuring a firm of accountants to make an additional claim.</p>
France	<p>While the statutory position is 30% withholding tax with a 15% reclaim allowed under the treaty, France does allow for UK pension funds to make full reclaims as a UK pension fund is similar to a French pension fund, which is allowed an exemption.</p> <p>In most instances, the full reclaim appears to be made by Northern Trust and therefore Lothian receives the correct amount. For 38 dividend distributions however, Northern Trust is showing a 15% reclaim instead of a 30% reclaim. The potential further reclaims amount to £64,544.</p>	<p>LPF comment:</p> <p>Query has been raised with NT.</p> <p>NT comment:</p> <p>NT would work to obtain the Double Tax Treaty rate (15% WHT) through either relief at source or reclaim. There is no process in place on obtain a further reclaim under domestic law.</p> <p>LPF comment:</p> <p>We are looking into the whether there is any merit in procuring a firm of accountants to make an additional claim.</p>
Germany	<p>While the statutory position is 26.375% withholding tax with a 16.375% reclaim allowed under the treaty, Germany does allow for UK pension funds to make full reclaims as a UK pension fund is similar to a German pension fund, which is allowed an exemption.</p> <p>In most instances, the full reclaim appears to be made by Northern Trust and therefore Lothian receives the correct amount. For 21 equity distributions however, Northern Trust is showing a 16.375% reclaim instead of a 26.375% reclaim. The potential further reclaims amount to £442,669.</p>	<p>LPF comment:</p> <p>Query has been raised with NT.</p> <p>NT comment:</p> <p>NT would submit reclaims at the Double Tax Treaty rate. Income would be received with 26.375% WHT and a reclaim would be submitted to recover 16.375% WHT. There is no process in place on obtain a further reclaim under domestic law.</p> <p>LPF comment:</p> <p>We are looking into the whether there is any merit in procuring a firm of accountants to make an additional claim.</p>
Taiwan WHT Rate	<p>The statutory rate in Taiwan is 20%, however a UK pension fund should be able to obtain a 10% withholding rate under the UK-Taiwan treaty.</p>	<p>Query has been raised with NT.</p> <p>NT comment:</p>



<b>Country</b>	<b>Findings</b>	<b>Conclusions as at Date of Preparation of Report to Pensions Audit Sub-Committee</b>
	There are a number of entries in the income report where no withholding tax is suffered. These should be investigated further.	Dividends and interest pays at the statutory rate. A local tax advisor would be needed to obtain treaty benefits.

# Pensions Audit Sub Committee

2.00p.m., Monday, 5 December 2016

## Lothian Pension Fund – Internal Audit Update 2016/17

Item number	5.5
Report number	
Executive/routine	
Wards	All

### Executive summary

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The purpose of this report is to provide a summary of Internal Audit Activity during the period 1 September 2016 to 30 November 2016.

The activity planned for the financial year 2016/17 was based on the allocation of internal audit resource across the City of Edinburgh Council's (CEC) services and was approved by the Pensions Committee and by the Governance, Risk and Best Value Committee in March 2016.

Three internal audit reviews were planned for the 2016/17 year:

- A review of the procedures surrounding internally managed investments;
- An external vulnerability assessment for online modules accessible to employers and members of the Lothian Pension Funds; and
- A review of governance arrangements for the Lothian Pension Fund group.

The review of internally managed investments was considered at the September Pensions Audit Sub-Committee meeting. The other reviews are considered in this report.

### Links

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Coalition pledges

Council outcomes [CO26](#)

Single Outcome Agreement

## Lothian Pension Fund – Internal Audit Update 2016/17

### Recommendations

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- 1.1 Committee is requested to:
- note the Internal Audit activity during the period 1 April to 31 August 2016;
  - note the matters arising from the Internal Audit review undertaken in this period; and
  - note the status of management actions from audits undertaken in 2015/16, and in 2016/17.

### Background

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#### Internal Audit Plan 2016/17

- 2.1 The internal audit plan for the Lothian Pension Fund (LPF) was set out in the Internal Audit report to the Pensions Committee on 15 March 2016.
- 2.2 The internal audit plan for the Fund is risk based with a focus on governance, risk and controls. The areas identified for inclusion in the plan were determined following discussions with LPF management and examination of risk registers.
- 2.3 The plan for 2016/7 included three planned Internal Audit reviews:
- a review of the procedures surrounding internally managed investments;
  - an external vulnerability assessment for online modules accessible to employers and members of the Lothian Pension Funds; and
  - a review of governance arrangements for the Lothian Pension Fund group.
- 2.4 The review of internally managed investments was reported to the Pensions Audit Sub-Committee in September. The other reviews are considered in this report.

### Main report

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#### Third party ICT supplier risk

- 3.1 We completed an external vulnerability assessment for online modules accessible to employers and members of the Lothian Pension Fund, which are operated by third party ICT suppliers. This review identified one high and one medium risk finding. Due to the sensitive nature of these findings, it is suggested that this audit report is considered in private as a 'B' agenda item.

## Governance arrangements at the Lothian Pension Fund group

- 3.2 LPFE Ltd. and LPFI Ltd. were incorporated in February 2015 as arm's length companies within the Lothian Pension Fund group. We carried out a 'Review Recommend' over the Group's governance and HR arrangements: we identified the controls currently in place, assessed whether they were appropriate for the LPF Group in its current state of development, and identified areas where management may wish to enhance their processes and controls as the companies establish themselves and activity increases.
- 3.3 We also conducted a compliance audit of payroll controls, HMRC returns including corporation tax, employment taxes and V.A.T., and Companies House returns.
- 3.4 This review identified one medium and one low risk finding:

Summary of finding & management response	Grading
<p><b><i>Reward strategy</i></b></p> <p>Transparency of remuneration for LPFE Ltd employees would be enhanced by defining a reward strategy, which we would recommend is referred to the Pensions Committee for scrutiny as a 'B' agenda item.</p>	<p><b>Medium</b></p>
<p><b><i>Management response</i></b></p> <p>The LPFE Ltd Board is in the process of reviewing the reward strategy, which will be communicated to stakeholders.</p>	
<p><b><i>Companies House: termination of appointments</i></b></p> <p>There were delays in removing ex officio directors from the board of LPFE Ltd and LPFI Ltd when they left the Council, and in notifying Companies House. Companies House should be notified within 2 weeks when an appointment is terminated.</p>	<p><b>Low</b></p>
<p><b><i>Management response</i></b></p> <p>LPF accept this finding and will ensure that these matters are dealt with in a timely manner going forward.</p>	

- 3.5 For greater detail on the findings of this audit, including good practice identified and advisory findings from our 'Review Recommend' of HR and Governance arrangements, please see the full report which is in Appendix 1.

## Open recommendations

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- 4.1 At the end of each month, Internal Audit prepares a complete listing of all open recommendations across the Council and shares these with Management on a divisional or line of service basis. Internal Audit then invites management to identify which recommendations they consider to have been addressed or which are no longer relevant.
- 4.2 Internal Audit will review Management’s supporting evidence for recommendations that Management consider to be closed and feedback their view on whether this is the case. Recommendations that are agreed as closed have their status updated in Internal Audit’s records.
- 4.3 We conducted 3 Pension Fund specific reviews in 2015/16, and 1 review in Q1 2016/17. All recommendations from previous audit years are closed.

Review	Findings		
	High	Medium	Low
Immediate Payments	-	2	3
Pension Compliance	-	2	2
Externally managed investments	-	-	-
<b>Total 15/16</b>	-	<b>4</b>	<b>5</b>
Internally managed investments	-	-	3
<b>Total 16/17</b>	-	-	<b>3</b>

- 4.4 The total number of audit actions which remain open is set out below:

Review	Findings		
	High	Medium	Low
Pension Compliance	-	1	-
Internally Managed Investments	-	-	-
<b>Total</b>	-	<b>1</b>	-

- 4.5 There is one outstanding audit action from the Pension Compliance review completed in 2015/16. This concerned the requirement under Local Government Pension Scheme regulations to ring-fence any monies held by a local authority on behalf of a pension scheme in a separate account with a deposit taker.
- 4.6 Strain payments and pension contributions are now paid directly into the LPF bank account, and the holding account is cleared fully each month, which substantially reduces the amount held by the Council on behalf of LPF at any point in time. LPF has also been investigating setting up separate purchase and sales ledgers for the Fund, but this is dependent on the implementation of the Council’s new ERP system which has been delayed until April 2017. As such this action remains open.

## Measures of success

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- 5.1 Alignment of the Internal Audit Plan to the key risks faced by the Fund to ensure governance is improved, responsibility is taken for corrective action and confidence in the management of risk is increased.

## Financial impact

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6.1 There are no direct financial implications.

## Risk, policy, compliance and governance impact

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7.1 There are no adverse impacts arising from this report.

## Equalities impact

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

## Sustainability impact

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

## Consultation and engagement

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

## Background reading / external references

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None.

Magnus Aitken, Chief Internal Auditor

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## Links

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### 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 – Governance of LPF Group

# ***The City of Edinburgh Council***

## **Internal Audit**

**Lothian Pension Fund**

**Governance of LPF Group**

Final Report

November 2016

# Contents

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This internal audit review is conducted for the City of Edinburgh Council under the auspices of the 2016/17 internal audit plan approved by the Governance, Risk and Best Value Committee in March 2016. The review is designed to help the City of Edinburgh Council assess and refine its internal control environment. It is not designed or intended to be suitable for any other purpose and should not be relied upon for any other purpose. The City of Edinburgh Council accepts no responsibility for any such reliance and disclaims all liability in relation thereto.

The internal audit work and reporting has been performed in line with the requirements of the Public Sector Internal Audit Standards (PSIAS) and as a result is not designed or intended to comply with any other auditing standards.

Although there is 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 City of Edinburgh 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	1
Low	1
Advisory	2
<b>Total</b>	<b>4</b>

## Summary of findings

LPFE Ltd. and LPFI Ltd. were incorporated in February 2015 as arm's length companies within the Lothian Pension Fund group. LPFI Ltd was dormant throughout 2015/16, receiving FCA authorisation in July 2016, while the transition of staff from City of Edinburgh Council to LPFE Ltd took place during 2015/16. A 'Review Recommend' was carried out over the Group's governance and HR arrangements given that the LPF Group companies are only recently established: we identified the controls currently in place, assessed whether they were appropriate for the LPF Group in its current state of development, and identified areas where management may wish to enhance their processes and controls as the companies establish themselves and activity increases.

We also conducted a compliance audit of payroll controls, of HMRC returns including corporation tax, employment taxes and V.A.T., and of Companies House returns.

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

- HMRC returns are submitted accurately and on time.
- Payments to LPFE Ltd employees are valid, complete and accurate.
- There is clear accountability for and oversight of the activities of LPFE Ltd and LPFI Ltd, and transparency over the use of public funds.
- There is clarity over the HR policies and procedures which apply to employees of LPFE Ltd.
- There is adequate scrutiny of remuneration for LPFE Ltd employees.

The following areas for improvement were identified:

- Transparency of remuneration would be enhanced by defining a reward strategy.
- Companies House should be notified within 2 weeks when an ex officio directorship is terminated because the officer has left the Council.

There were two advisory findings arising from the 'review recommend' of HR and governance arrangements:

- As LPFI Ltd begins to offer investment services to external bodies, management should consider

developing a standard reporting package to give those organisations information about investment strategy and performance, and assurance over investment controls in place at LPFI Ltd.

- Management should satisfy themselves that auditor independence is not impaired by non-audit services and consider obtaining audit committee approval for non-audit services provided by the external auditors of LPFI and LPFE Ltd.

Our detailed findings and recommendations are laid out within Section 2: *Review Recommend* and Section 3: *Detailed findings*.

# 1. Background

## Background

LPFE Ltd. (LPFE) and LPFI Ltd. (LPFI) were incorporated as limited companies wholly owned by the City of Edinburgh Council in February 2015. They were set up to enable Lothian Pension Fund (LPF) to develop its investment management function and seek FCA authorisation for LPFI (awarded in July 2016). 11 members of the LPF investment and management teams transferred their employment to LPFE in 2015. These staff are seconded to LPFI, City of Edinburgh Council (as administrators of LPF) and to Falkirk Council.

This audit took two parts: a compliance audit of payroll controls, HMRC returns including corporation tax, employment taxes and V.A.T., and of Companies House returns; and a 'Review Recommend' of the developing governance and HR arrangements. See Appendix 2 for the full terms of reference.

## *Payroll and Compliance*

LPFE has appointed Scott Moncrieff as its payroll service provider with 121 HR Solutions providing HR support. Scott Moncrieff maintains payroll records, processes the monthly payroll, and administers PAYE and other HMRC returns. Scott Moncrieff also administers corporation tax for LPFE and LPFI.

We reviewed the design and operating effectiveness of payroll controls, and the accuracy of a sample of payments. There was sufficient segregation of duties over the monthly payroll at LPFE, with payroll input approved by 2 authorised signatories before it is processed by Scott Moncrieff, and variation reports and BACS reports then reviewed by 2 of the 4 authorised signatories before the payment is processed. The payments in the sample reviewed were found to be accurate.

Companies House and HMRC returns were timely and accurate, with the exception of notifications due to Companies House when a new director is appointed. See Finding 2.

## *Governance and HR Arrangements*

LPFE and LPFI operate as arm's length external organisations, with City of Edinburgh Council (as Lothian Pension Fund) their primary client. This is a new arrangement and as such it is important that there is clarity over the governance arrangements to maintain accountability and transparency over the use of public funds, while enabling LPF to develop its investment management function through the two companies.

LPFE was set up as an employment services company, with 11 members of the investment and management teams transferring their employment to LPFE from CEC in 2015. LPFE appointed 121 HR Solutions Ltd to provide HR services and advise on the development of employment contracts and HR policies. PwC were appointed to benchmark salaries against market rates and advise on remuneration. Salaries were approved by the Board in December 2015, and employment contracts were signed in April 2016.

We have reviewed the governance and HR arrangements currently in place at LPFE and LPFI, and assessed their suitability for the Group in its current stage of development. Our assessment is detailed in Section 2: *Review Recommend*.

## 2. Review Recommend


Objective	Existing Controls	Findings
<p>There is clear accountability for and oversight of the activities of LPFE Ltd and LPFI Ltd, and transparency over the use of public funds.</p>	<ul style="list-style-type: none"> <li>- The Pensions Audit Sub-Committee is responsible for the scrutiny of LPF arm's length companies. It receives an annual report, which includes an overview of the governance arrangements and activity during the year, and the audited financial statements.</li> <li>- The Pensions Audit Sub-Committee has been briefed on the strategic direction of LPFI Ltd at key stages. Due to the commercial sensitivity of LPFI's activities, these updates have appeared on the 'B' agenda, which seems appropriate.</li> <li>- The Pensions Committee will continue to receive annual reports on the performance of the Funds, investment controls and the investment strategy.</li> <li>- The Council's Executive Director of Resources is a director of both LPFE and LPFI. An elected member and Chair of the Pensions Committee also acts as Chair of the LPFE Board.</li> <li>- LPFI is currently recruiting a non-executive director to enhance scrutiny and bring membership in line with the UK Corporate Governance Code.</li> </ul>	<p><b>Investment reporting (Advisory)</b></p> <p>We consider that the current governance and reporting arrangements in the LPF Group are satisfactory. Members and senior Council officers will continue to receive full reporting on investment strategy, performance and controls for the Lothian Pension Funds. This reporting should enable members to assess the impact of increased activity by LPFI on the Funds.</p> <p>As LPFI grows and offers investment advisory services to external organisations, management should review the investment reporting package. Depending on the services provided by LPFI, LGPS clients are likely to require a suite of reports to enable their Investments and Pensions Committees to monitor the performance of funds and to give them assurance over the controls in place at LPFI. As a minimum we would expect this to include an investment strategy, investment performance reporting, and a controls report.</p> <p><i>Management response: LPFI will not necessarily have an ongoing relationship with each pension fund once the investment is made, or a role in monitoring and reporting on the investments. Nevertheless, where appropriate to the relationship with that pension fund, we agree that reporting will need to be reviewed.</i></p>

<p>There is clarity over the HR policies and procedures which apply to employees of LPFE Ltd.</p>	<ul style="list-style-type: none"> <li>- All LPFE Ltd employees have signed an employment contract which is supported by an employee handbook. The handbook sets out the policies of LPFE Ltd, including a code of conduct, relevant financial sector policies such as anti-bribery, and performance and absence management policies. The handbook was developed with the support of an external HR provider.</li> </ul>	<p>None</p>
<p>There is adequate scrutiny of remuneration for LPFE Ltd employees.</p>	<ul style="list-style-type: none"> <li>- An external provider was appointed to benchmark salaries and recommend a pay structure. The starting salaries of LPFE employees are within the recommended ranges.</li> <li>- Pay scales and starting salaries were approved by the LPFE Board.</li> <li>- Three of the four members of the LPFE Board are not employees of LPFE. Membership comprises an elected member and Chair of the Pensions Committee, the Council's Head of HR, the Council's Executive Director of Resources, and the Chief Executive of Lothian Pension Fund.</li> </ul>	<p><b>Reward strategy (Medium)</b></p> <p>The LPFE Board has not yet defined a reward strategy establishing the principles they will use to set remuneration. The benchmarking exercise is currently being repeated to determine salaries for 2016/17, and inform the development of a performance-related pay scheme, if the Board decides to introduce one.</p> <p>Given that the establishment of an employment service company is a new development for the Council, it is likely to attract significant scrutiny from members. Defining a reward strategy may be an effective way of assuring members that salaries are set at a level which does deliver best value, and within agreed parameters.</p> <p><i>See Finding 1.</i></p> <p><b>Non-audit services (Advisory)</b></p> <p>Scott Moncrieff is the payroll provider for LPFE and also its external auditor. This arrangement is permitted for a non-regulated company such as LPFE, but we would recommend that management satisfy themselves that there is sufficient separation between Scott Moncrieff's payroll and audit services, and that it does not affect the firm's ability to provide an independent</p>

		<p>audit. We would also recommend that management consider obtaining audit committee approval for non-audit services provided by the company's external auditor.</p> <p><i>Management response: Agreed. We will report to Committee on non-audit services provided by Scott Moncrieff by 31 March 2017.</i></p>
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## 2. Detailed findings

### 1. Reward strategy

Findings	
<p>The salaries of LPFE Ltd employees were finalised in February 2016 following a benchmarking exercise undertaken by PwC. The starting salaries approved by the LPFE Board were within the range recommended by PwC, and in the lower- to mid- quartiles when benchmarked against similar roles.</p> <p>Pay brackets for each role were approved by the Board, but at present there is no mechanism (such as a performance-related pay scheme) for employees to progress from their starting salary within that bracket. As such, the benchmarking exercise has been repeated, and the Board will be considering options for salary points and performance-related pay in the near future.</p> <p>We note that stakeholders have expressed a wish to be briefed on reward at LPFE Ltd, now that the employees are removed from the Council's pay structure. There are barriers to doing this in a public forum due to the commercial sensitivity of the payroll information, and that, due to the small number of employees, individuals would be identifiable.</p>	
Business Implication	Finding Rating
<p>The Pensions Board and elected members may not have the desired assurance that salaries are reasonable and constitute best value for LPF, while addressing the staff recruitment and retention risk.</p>	

Action plans	
Recommendation	Responsible Officer
<p>We recommend that the LPFE Ltd Board agrees a Reward Strategy, which is referred to the Pensions Committee as a 'B' agenda item. This should set out the principles the Board uses in setting pay (for example, pay is benchmarked every 3 years to the lower quartile), the salary range for each banding, and an outline of how employees can progress within their banding.</p> <p>We note that, as a director of LPFE Ltd, the chief executive's salary is published anyway. It may therefore be appropriate to obtain Committee approval for this pay point.</p>	<p>Chief Executive Officer</p>
Agreed Management Action	Estimated Implementation Date
<p>Agreed. The LPFE Board is in the process of reviewing reward strategy and this will be communicated to stakeholders.</p> <p>Committee's approval for the Chief Executive Officer remuneration will be obtained.</p>	<p>31 March 2017</p>

## 2. Companies House: Termination of Appointment

### Findings

Companies are required to register a change of director with Companies House within 2 weeks of the appointment or termination.

We reviewed Companies House records and noted that:

- Alistair Maclean was listed as a director of LPFI Ltd and LPFE Ltd until 19 January and 19 February 2016 respectively, but left the Council in December 2015. The termination of his appointment was not filed with Companies House until 23 March 2016.
- Linda Holden left the Council in July 2015 but remained a director of LPFE Ltd until 10 December 2015. The termination of her appointment was not filed with Companies House until 23 March 2016.
- Martin Glover is currently listed as a director of LPFE Ltd, but left the Council in August 2016.

### Business Implication

- A former employee of the Council who no longer attends board meetings is legally a director of LPFE Ltd.
- Companies House filing deadlines have not been met.

### Finding Rating

Low

### Action plans

#### Recommendation

Where a Council officer is a board member in an ex officio post, the appointment should be terminated when they resign from their Council post. Arrangements should be made with the Council's HR department and the director themselves to ensure that the LPF Group is notified promptly when a director tenders their resignation, and that all necessary paperwork to remove them as legal directors of the company is completed before they leave the Council.

The resignation or appointment of a director should be registered with Companies House within 2 weeks.

#### Responsible Officer

Chief Risk Officer

#### Agreed Management Action

Agreed. We will ensure that matters are dealt with in a timely manner going forward.

#### Estimated Implementation Date

31 December 2016



# Appendix 1 - Basis of our classifications

Finding rating	Assessment rationale
<b>Critical</b>	<p>A finding that could have a:</p> <ul style="list-style-type: none"> <li>• <b>Critical</b> impact on operational performance; or</li> <li>• <b>Critical</b> monetary or financial statement impact; or</li> <li>• <b>Critical</b> breach in laws and regulations that could result in material fines or consequences; or</li> <li>• <b>Critical</b> impact on the reputation or brand of the organisation which could threaten its future viability.</li> </ul>
<b>High</b>	<p>A finding that could have a:</p> <ul style="list-style-type: none"> <li>• <b>Significant</b> impact on operational performance; or</li> <li>• <b>Significant</b> monetary or financial statement impact; or</li> <li>• <b>Significant</b> breach in laws and regulations resulting in significant fines and consequences; or</li> <li>• <b>Significant</b> impact on the reputation or brand of the organisation.</li> </ul>
<b>Medium</b>	<p>A finding that could have a:</p> <ul style="list-style-type: none"> <li>• <b>Moderate</b> impact on operational performance; or</li> <li>• <b>Moderate</b> monetary or financial statement impact; or</li> <li>• <b>Moderate</b> breach in laws and regulations resulting in fines and consequences; or</li> <li>• <b>Moderate</b> impact on the reputation or brand of the organisation.</li> </ul>
<b>Low</b>	<p>A finding that could have a:</p> <ul style="list-style-type: none"> <li>• <b>Minor</b> impact on the organisation's operational performance ; or</li> <li>• <b>Minor</b> monetary or financial statement impact; or</li> <li>• <b>Minor</b> breach in laws and regulations with limited consequences; or</li> <li>• <b>Minor</b> impact on the reputation of the organisation.</li> </ul>
<b>Advisory</b>	<p>A finding that does not have a risk impact but has been raised to highlight areas of inefficiencies or good practice.</p>

# Appendix 2 – Terms of Reference

To: Hugh Dunn

From: Gemma Dalton  
Principal Audit Manager

Date: 16 August 2016

Cc: Clare Scott, John Burns, Struan Fairbairn

This review is being undertaken as part of the 2016/17 internal audit plan approved by the Pension Committee in March 2016.

## Background

LPFE Ltd and LPFI Ltd were incorporated as limited companies wholly owned by the City of Edinburgh Council in February 2015. They were set up to enable Lothian Pension Fund (LPF) to develop its investment management function and seek FCA authorisation for LPFI (awarded in July 2016). 11 members of the LPF investment and management teams transferred their employment to LPFE Ltd in 2015. These staff are seconded to LPFI Limited, City of Edinburgh Council (as administrators of LPF) and to Falkirk Council.

## Scope

The scope of this review will be to assess the LPF group's governance arrangements, and assess the design and operating effectiveness of the Council's controls relating to HR and payroll for staff employed by LPFE Ltd.

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

Sub-process	Control Objectives
Governance	<ul style="list-style-type: none"><li>• There is clear accountability for and oversight of the activities of LPFE Ltd and LPFI Ltd, and transparency over the use of public funds.</li><li>• Required Companies House and other regulatory and/or statutory returns are submitted accurately and on time.</li><li>• HMRC returns are submitted accurately and on time.</li></ul>
HR & Payroll	<ul style="list-style-type: none"><li>• There is clarity over the HR policies and procedures which apply to employees of LPFE Ltd (e.g. employment contract, code of conduct, absence, performance, disciplinary).</li><li>• There is adequate scrutiny of remuneration for LPFE Ltd employees.</li><li>• Payments to LPFE Ltd employees are valid, complete and accurate.</li></ul>

## Limitations of Scope

The scope of our review is outlined above. Testing will be undertaken on a sample basis for the period 1 May 2015 to 31 August 2016.

## Approach

The City of Edinburgh Council  
Internal Audit Report – Governance of LPF Group

Our audit approach is as follows:

- Obtain an understanding of LPF group governance, HR and payroll through discussions with key personnel, review of systems documentation and walkthrough tests;
- Identify the key risks around LPF group governance, taxation and HR and payroll;
- Evaluate the design of the controls in place to address the key risks; and
- Test the operating effectiveness of the key controls.

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### Internal Audit Team

Name	Role	Contact Details
Magnus Aitken	Chief Internal Auditor	0131 469 3143
Gemma Dalton	Principal Audit Manager	0131 469 3077

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### Key Contacts

Name	Title	Role	Contact Details
Hugh Dunn	Acting Executive Director of Resources	Review Sponsor	0131 469 3150
Clare Scott	Chief Executive Officer	Key contact	0131 469 3865
John Burns	Chief Finance Officer	Key contact	0131 469 3711
Struan Fairbairn	Chief Risk Officer	Key contact	0131 529 4689
Esmond Hamilton	Financial Controller	Key contact	0131 469 3521

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### Timetable

Fieldwork Start	30 August 2016
Fieldwork Completed	14 September 2016
Draft report to Auditee	16 September 2016
Response from Auditee	7 October 2016
Final Report to Auditee	14 October 2016

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### Follow Up Process

Where reportable audit findings are identified, the extent to which each recommendation has been implemented will be reviewed in accordance with estimated implementation dates outlined in the final report.

Evidence should be prepared and submitted to Audit in support of action taken to implement recommendations.

Actions remain outstanding until suitable evidence is provided to close them down.

Monitoring of outstanding management actions is undertaken via monthly updates to the Director and his business manager. The business manager liaises with service areas to ensure that updates and appropriate evidence are provided when required.

Details of outstanding actions are reported to the Governance, Risk & Best Value (GRBV) Committee on a quarterly basis.

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## 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:

- Legal pack for LPFE Ltd and LPFI Ltd
- Service agreements with CEC, LPFE/LPFI Ltd, and Falkirk Council
- Agreements with external service providers

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.