Notice of meeting and agenda

Pensions Committee

2pm, Tuesday, 18 December 2012

Dunedin Room, City Chambers, High Street, Edinburgh

This is a public meeting and members of the public are welcome to attend

Contact

Gavin King

Senior Committee Officer

E-mail: Gavin.king@edinburgh.gov.uk

Tel: 0131 529 4239

1. Order of business

1.1 Including any notices of motion and any other items of business submitted as urgent for consideration at the meeting.

2. Declaration of interests

2.1 Members should declare any financial and non-financial interests they have in the items of business for consideration, identifying the relevant agenda item and the nature of their interest.

3. Deputations

3.1 None

4. Minute of Pensions & Trusts Committee of 3 October 2012

4.1 Previous Minute 3 October 2012 – Submitted for information. (circulated)

5. Reports

5.1 Governance of Lothian Pension Funds and Appointment of Pensions Audit Sub-Committee – report by the Director of Corporate Governance (circulated)

5.2 Annual Report on the 2011/12 Audit of the Lothian Pension Funds - report by the Director of Corporate Governance (circulated)

5.3 Investment Benchmarks and Objectives - report by the Director of Corporate Governance (circulated)

5.4 Environmental, Social and Governance Activity Update - report by the Director of Corporate Governance (circulated)

5.5 Class Actions - report by the Director of Corporate Governance (circulated)

5.6 Regulatory Update including Public Service Pensions Bill - report by the Director of Corporate Governance (circulated)

5.7 Service Plan 2012-2015 – Monitoring Update - report by the Director of Corporate Governance (circulated)

6. Motions

6.1 If any

Carol Campbell

Head of Legal, Risk and Compliance

Committee Members

Councillor Child (Convener), Councillor Bill Cook, Councillor Orr, Councillor Rankin, Councillor Rose, Alison Cosgrove and Darren May.

Information about the Pensions Committee

The Pensions Committee consists of 5 Councillors and 2 external members and is appointed by the City of Edinburgh Council. The Pensions Committee usually meets every eight weeks.

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

Further information

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

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

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

EDINBURGH
THE CITY OF EDINBURGH COUNCIL

Item no 4.1

Committee Minutes

Pensions and Trusts Committee

Edinburgh, 3 October 2012

Present:- Councillors Child (Convener), Bill Cook, Orr and Rose.

Also Present:

Members of the Consultative Panel – Eric Adair, Archie Arnott, Allison Cosgrove, Eric MacLennan, Darren May and Norman Strachan.

Audit Scotland – Brendan Clark.

1 Minute

Decision

To approve the minute of the Pensions and Trusts Committee of 27 June 2012 as a correct record.

2 Audited Pension Funds Annual Report 2011/12

The external auditor's report on the audit of the Lothian Pension Funds Annual Report 2011/12 was presented in compliance with the requirements of the International Standard on Auditing (ISA) 260. The ISA 260 report had also been considered by the Council's Audit Committee.

Brendan Clark (Audit Scotland) highlighted the principal areas covered in the report and responded to questions from members.

Decision

1) To note the contents of the ISA 260 report.

2) To note the Audited Pension Funds Annual Report for the year ended 31 March 2012.

(References – Audit Committee 27 September 2012 (item 2(a)); report by the Director of Corporate Governance, submitted.)

3 Review of Pension Fund Governance

An update was given on the Lothian Pension Funds' governance arrangements and constitutional changes to the Consultative Panel were proposed, following approval of the Council's new governance arrangements.

External legal advice on the issue of liability in respect of elected members and external members of the Pensions Committee was detailed and a Code of Conduct for members of the Committee and the Consultative Panel was proposed.

Decision

1) To note the changes to pension fund governance agreed by the Council in September 2012.

2) To note the external legal advice regarding the position from a liability perspective with regard to members of the Pensions Committee, including the external members.

3) To approve the updated constitution and the guidance on the operation of the Consultative Panel as detailed in appendix 2 to the report by the Director of Corporate Governance.

4) To agree that a Governance Policy Statement was no longer required.

5) To ask the Director of Corporate Governance to report further on the Code of Conduct for members of the Pensions Committee and the Lothian Pension Funds' Consultative Panel.

6) To note that the new arrangements would be put in place over the coming months and an update provided to the next Pensions Committee in December.

(References – Pensions and Trusts Committee 27 June 2012 (item 7); Act of Council No 8 of 20 September 2012; report by the Director of Corporate Governance, submitted.)

4 Investment Strategy Review – Lothian Pension Fund

The conclusions of the review of investment strategy of the Lothian Pension Fund were detailed and approval was sought for amendments to the Fund's investment strategy.

Decision

1) To note the review of investment strategy, the inherent volatility in investment markets and the challenges faced by the Fund over the next 3-5 years due to weaknesses in global economies.

2) To approve the revised investment strategy and asset allocation ranges for the Lothian Pension Fund as detailed in paragraph 3.3.2 of the report by the Director of Corporate Governance.

3) To delegate investment activity outwith the agreed strategy and asset allocation ranges in the event of extreme investment market fluctuations to the Director of Corporate Governance, in consultation with the Convener of the Pensions Committee, with the activity reported to the Pensions Committee.

4) To delegate the implementation of the revised investment strategy and the themes identified to the Director of Corporate Governance in consultation with the Investment Strategy Panel.

5) To instruct the Director of Corporate Governance to review the budgetary and staffing implications of the revised investment strategy and report the conclusions of the review to the Committee.

6) To agree that there should not be a specific outperformance target and note that the future focus on risk, income and capital protection was likely to mean that the Fund would perform better if markets fell significantly but would perform less well if equity markets rose significantly.

7) To agree to consider requests for low-risk investment strategies for different employers, subject to practicalities of implementation.

(References – Pensions and Trusts Committee 27 June 2012 (item 8); report by the Director of Corporate Governance, submitted.)

5 Investment Strategy Review – Lothian Buses Pension Fund

The conclusions of the review of investment strategy of the Lothian Buses Pension Fund were detailed and approval was sought for amendments to the Fund's investment strategy.

Decision

1) To note the review of investment strategy, the inherent volatility in investment markets and the challenges faced by the Fund over the next 3-5 years due to weaknesses in global economies.

2) To approve the revised investment strategy and asset allocation ranges for the Lothian Buses Pension Fund as detailed in paragraph 3.3.2 of the report by the Director of Corporate Governance.

3) To delegate investment activity outwith the agreed strategy and asset allocation ranges in the event of extreme investment market fluctuations to the Director of Corporate Governance, in consultation with the Convener of the Pensions Committee, with the activity reported to the Pensions Committee.

4) To delegate the implementation of the revised investment strategy to the Director of Corporate Governance in consultation with the Investment Strategy Panel.

5) To agree that there should not be a specific outperformance target and note that the future focus on risk, income and capital protection was likely to mean that the Fund would perform better if markets fell significantly but would perform less well if equity markets rose significantly.

References – Pensions and Trusts Committee 27 June 2012 report by the Director of Corporate Governance, submitted.)

6 Investment Strategy Review – Scottish Homes Pension Fund

The conclusions of the review of investment strategy of the Scottish Homes Pension Fund were detailed and approval was sought for amendments to the Fund's investment strategy.

Decision

1) To note the review of investment strategy, the inherent volatility in investment markets and the challenges faced by the Fund over the next 3-5 years due to weaknesses in global economies.

2) To approve the revised investment strategy and asset allocation ranges for the Scottish Homes Pension Fund as detailed in paragraph 3.3.2 of the report by the Director of Corporate Governance.

3) To delegate investment activity outwith the agreed strategy and asset allocation ranges in the event of the actual funding level exceeding the target funding level or in the event of extreme investment market fluctuations to the Director of Corporate Governance, with the activity reported to the Pensions Committee.

4) To delegate the implementation of the revised investment strategy to the Director of Corporate Governance in consultation with the Investment Strategy Panel.

5) To agree that there should not be a specific outperformance target and note that the future focus on risk, income and capital protection was likely to mean that the Fund would perform better if markets fell significantly but would perform less well if equity markets rose significantly.

6) To note the further investigations into potential use of any surplus which might arise in the Fund and the use of other vehicles to reduce risk.

(References – Pensions and Trusts Committee 27 June 2012 (item 10); report by the Director of Corporate Governance, submitted.)

7 Statement of Investment Principles

A revised Statement of Investment Principles for the Pension Funds was proposed for adoption to replace the statement agreed by the Committee in June 2011.

Decision

To adopt the revised Statement of Investment Principles.

(References – Pensions and Trusts Committee 28 June 2011 (item 7); report by the Director of Corporate Governance, submitted.)

8 Update on Employers' Participation in Lothian Pension Fund

Updates were provided on:

- employers who had recently joined the fund and employers currently looking to join;
- college mergers; and
- current matters relating to the Forth Estuary Transport Authority, Police and Fire Services reform and the Lothian Centre for Inclusive Living.

Decision

To note the report.

(References – Pensions and Trusts Committee 28 March 2012 (item 10); report by the Director of Corporate Governance, submitted.)

9 Service Plan 2012-2015 Monitoring Update

An update was provided on the 2012-2015 Service Plan objectives for Lothian Pension Fund (including Lothian Buses and Scottish Homes Pension Funds) and the projected outturn for 2012/13 compared to the approved budget.

Decision

To note the report.

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

10 Charitable Trusts Update on Consolidation

An update was provided on the plan to consolidate and simplify the administration of existing trusts. The consolidation aimed to make the management and administration of the trusts more effective in order to maximise the benefit of the funds. The main elements of the plan to reorganise the Council's trust funds were nearing completion.

Details were given on the conditional award of funding from the Boyd Anderson Trust to Save Our Suntrap and a recommendation was made on the safekeeping of the Boyd Anderson artefacts.

Following the Council's approval of its new governance arrangements, governance of the charitable trusts would be transferred from the Pensions and Trust Committee to the Finance and Budget Committee.

Decision

1) To keep the situation regarding the award of £57k from the Boyd Anderson Trust to Save Our Suntrap under review and report back to the Finance and Committee in due course.

2) To agree that the Boyd Anderson artefacts should be subject to the Council's Museums and Galleries Acquisition and Disposal Policy.

3) To note the proposed new arrangements for the governance of the remaining trust funds.

4) To thank the Fund Accounting Manager for his work on the consolidation of the charitable trusts.

(References – Pensions and Trusts Committee 28 March 2012 (item 3); report by the Director of Corporate Governance, submitted.)

Pensions Committee

2pm, Tuesday, 18 December 2012

Governance of Lothian Pension Funds & Appointment of Pensions Audit Sub-Committee

Item number	5.1
Report number	
Wards	All

Links

Coalition pledges	
Council outcomes	CO26
Single Outcome Agreement	

Alastair Maclean

Director of Corporate Governance

Clare Scott, Investment & Pensions Service Manager

E-mail: clare.scott@edinburgh.gov.uk | Tel: 0131 469 3865

Executive summary

Governance of Lothian Pension Funds

Summary

Following revisions to the constitution of the Consultative Panel in October 2012, applications have been sought. The following table shows the membership of the new Panel.

Member representatives	
Alison Cosgrove	UNISON
John Rodgers	UNITE
Eric Maclennan	UNISON
Owen Murdoch	UNISON Retired member
Charlie Boyd	Active Member
Vacancy	
Employer representatives	
Darren May	Scottish Water
Guy Hughes	Lothian Buses
Alan Williamson	Edinburgh Colleges
Eric Adair	EDI
Appointment by Scottish Office	Scottish Homes
Vacancy	

The Panel met on 5 November and nominated the following for membership of the Pensions Committee for one year:

- Darren May, HR Manager, Scottish Water as employer representative;
- Alison Cosgrove, Unison, East Lothian Council as member representative.

On 22 November 2012, Council agreed the appointments.

A Code of Conduct, issued by the Scottish Government, applies to every elected member of a local authority in Scotland and so would apply to an individual's elected member's role on a Pensions Committee. It applies only to elected members and not to co-opted members of local authority committees. However, co-opted members are expected to apply the same high standards of conduct as elected members. The Council should, therefore, expect co-opted members of the Pensions Committee to comply with the Code and this should be made a condition of their appointment. The Code of Conduct has been tailored for the Pensions Committee and Consultative Panel. It is attached as Appendix 1 for approval.

A Pensions Audit Sub-Committee consisting of 3 members (including at least 2 elected members from City of Edinburgh Council) will undertake the audit scrutiny of the pension funds. It is expected to meet twice per year (March and August/September) and will cover issues relating to financial statements, internal and external audit and risk control framework. The Committee is asked to appoint the members of the Sub-Committee.

The Pensions Audit Sub-Committee will be supplemented by the attendance of two representatives from the Consultative Panel who will respond to all relevant matters in a non-voting capacity. The Panel has agreed that Eric Maclennan and Eric Adair will undertake this role.

Committee has previously agreed to appoint an independent observer to assist it in ensuring good governance of the pension funds. The search for an independent observer has commenced and is expected to conclude ahead of the Committee meeting in March 2013. Committee members are requested to participate in the selection process and select the preferred candidate.

Recommendations

1. To note the external appointments to the Pensions Committee.
2. To approve the Code of Conduct for members of the Pensions Committee and the Lothian Pension Funds' Consultative Panel.
3. To make appointments to the Pensions Audit Sub Committee.
4. To note the progress on appointing an independent observer.

Measures of success

Strengthened governance for the benefit of the pension funds and their stakeholders.

Financial impact

There are no direct financial implications of this report. Costs associated with the governance of the pension funds are included in the pension funds' budget.

Equalities impact

There are no environmental implications as a result of this report.

Sustainability impact

There are no sustainability implications as a result of this report.

Consultation and engagement

There has been overwhelming support from pension fund stakeholders for the introduction of voting members other than City of Edinburgh Council elected members to the Pensions Committee. The Pensions & Trusts Committee was supportive of the change.

Background reading / external references

Not applicable.

Links

Coalition pledges	
Council outcomes	CO26 – The Council engages with stakeholders and works in partnerships to improve services and deliver agreed objectives.
Single Outcome Agreement	
Appendices	Appendix 1 - Code of Conduct

The City of Edinburgh Council

The Pensions Committee

Lothian Pension Funds' Consultative Panel (Panel)

Code of Conduct

December 2012

Contents

Introduction

The Pensions Committee is appointed under Section 57 of the Local Government (Scotland) Act 1973 to exercise all functions of the Lothian Pension Funds within the terms of the legislation.

The Pensions Committee is made up of 5 City of Edinburgh elected members and 2 external members offered to pension fund stakeholders, one employer representative and one member representative taken from the Lothian Pension Fund Consultative Panel (Panel).

Members of the Pensions Committee have responsibility for:

- exercising all functions of Lothian Pension Funds within the terms of the legislation
- determining the overall policy objectives of the pension funds in accordance with the best interests of fund members and with relevant legislation.
- determining the strategy for the investment of pension funds' monies including the variety and suitability of investments and to review and monitor investment arrangements.
- ensuring appropriate investment management arrangements are in place for pension funds monies and to review investment manager performance.
- establishing and maintaining arrangements for the effective management and administration of the pension funds including staffing and budgetary arrangements.
- approving the allocation of resources to the Investment and Pensions Division from the Revenue Budget and Capital Investment Programme of the Lothian Pension Funds.
- approving responses to consultation papers issued by government and other authorities.
- monitoring overall performance of the Lothian Pension Funds in the delivery of services and financial performance.

This document sets out a code of conduct for members of the Pensions Committee. It also applies to members of the Lothian Pension Funds Consultative Panel.

It is your personal responsibility to comply with this Code and review regularly, and at least annually, your personal circumstances with this Code in mind, particularly when your circumstances change. You must not, at any time, advocate or encourage any action contrary to this Code.

If you are uncertain about how the rules apply, you should seek advice from the Council's Director of Corporate Governance.

Breach of any provision of this Code may result in termination of your appointment as a member of the Committee and/or Panel, in addition to any other legal consequences that may attach to the breach in question.

Key principles

The general principles upon which this Code is based should be used for guidance and interpretation only. These general principles are:

Duty

You have a duty to uphold the law and act in accordance with the law and the public trust placed in you. You have a duty to act in the interests of the pension funds (which are administered by the Pensions Committee) and all the persons served by the pension funds.

Selflessness

You have a duty to act solely in the interests of the pension funds and all the persons served by the pension funds. You must not act in order to gain financial or other material benefit for yourself, your organisation, family or friends.

Integrity

You must not place yourself under any financial or other obligation to any individual or organisation that might reasonably be thought to influence you in the performance of your duties.

Objectivity

You must make any recommendations solely on merit.

Accountability and Stewardship

You are accountable to the Pensions Committee for your advice and actions. You have a duty to consider issues on their merits, taking account of the views of others, with a view to assisting the Pensions Committee to act prudently and in accordance with the law.

Openness

You have a duty to be as open as possible with the Pensions Committee about your advice and actions.

Honesty

You have a duty to act honestly. You must declare any private interests relating to your duties as a member of the Committee and/or Panel and take steps to resolve any conflicts arising in a way that protects the interests of the pension funds and all the persons served by the pension's funds.

Leadership

You have a duty to promote and support these principles by leadership and example, and to maintain and strengthen the public's trust and confidence in the integrity of the Pensions Committee.

Respect

You must respect all other members of the Committee and/or Panel and all Council employees, and the roles they play, treating them with courtesy at all times. Similarly you must respect members of the public when performing duties as a member.

You should apply the principles of this Code to your informal dealings in relation to the pension funds with such other persons no less scrupulously than at formal meetings of the Pension Committees. Good conduct must be observed in all situations where you act as a member of the Committee and/or Panel.

Gifts and Hospitality

You must not accept any offer by way of gift or hospitality which could give rise to real or substantive personal gain or a reasonable suspicion of influence on your part to show favour or disfavour to any individual or organisation. You should also consider whether there may be any reasonable perception that any gift received by your spouse or cohabitee or by any company in which you have a controlling interest, or by a partnership of which you are a partner, can or would influence your judgement. The term "gift" includes benefits such as relief from indebtedness, loan concessions, or provision of services at a cost below that generally charged to members of the public. You must never ask for gifts or hospitality.

You are personally responsible for all decisions connected with the acceptance of gifts or hospitality offered to you and for avoiding the risk of damage to public confidence in the Pensions Committee. As a general guide, it is usually appropriate to refuse offers except:-

(i) isolated gifts of a trivial character, the value of which must not exceed £50; or

(ii) normal hospitality associated with your duties and which would reasonably be regarded as appropriate.

You must not accept any offer of a gift or hospitality from any individual or organisation who is an applicant awaiting a decision from the Pensions Committee or who is seeking to do business or to continue to do business therewith. If you are making a visit for the purposes of carrying out your duties as a member of the Committee and/or Panel, then as a general rule you should ensure that the Council pays for the cost of this visit. You must not accept repeated hospitality or repeated gifts from the same source.

Confidentiality Requirements

Pensions Committee documents are generally open to the public. This should be the basis on which you normally work, but there may be times when you will be required to treat discussions, documents or other information relating to the pension funds or Pensions Committee in a confidential manner, in which case you must observe such requirements for confidentiality.

Such information is, however, for your individual use in carrying out your duties as a member of the Committee and/or Panel and must not be disclosed or in any way used for personal or party political advantage or in such a way as to discredit the Pensions Committee. This will also apply in instances where you hold the personal view that such information should be publicly available.

Appointments to Partner Organisations

You may be appointed or nominated by the Pensions Committee or the Council as a member of another body or organisation. If so, you will be bound by the rules of conduct of these organisations and your responsibility for any actions taken by you as a member of such an organisation will be to the organisation in question. You must also continue to observe the rules of this Code in carrying out the duties of that body.

Declaration and registration of interests

Declaration of interest, along with registration of interests, are intended to produce transparency in regard to interests which might influence, or be thought to influence, your actions as a member of the Committee and/or Panel. A financial or other interest arising by virtue of membership of any of the pension funds does not have to be declared.

It is your responsibility to make decisions about whether you have to declare an interest or make a judgement as to whether a declared interest prevents you from taking part in any discussions. You are in the best position to assess your personal circumstances and to judge how these circumstances affect your role as a member of the Committee and/or Panel in regard to a particular matter. You can, of course, seek advice from appropriate Council officers or from other sources which may be available to you. In making decisions for which you are personally responsible you are advised to err on the side of caution.

Making a Declaration

You must consider at the earliest stage possible whether you have an interest to declare in relation to any matter which is to be considered. You should consider whether agendas for meetings raise any issue of declaration of interest. Your declaration of interest must be made as soon as practicable at a meeting where that interest arises. If you do identify the need for a declaration of interest only when a particular matter is being discussed you must declare the interest as soon as you realise it is necessary.

The oral statement of declaration of interest should identify the item or items of business to which it relates. The statement should begin with the words "I declare an interest". The statement must be sufficiently informative to enable those at the meeting to understand the nature of your interest but need not give a detailed description of the interest.

Public confidence in a public body is damaged by perception that the body’s decisions are substantially influenced by factors other than the public interest. If you would have to declare interests frequently at meeting of the Pensions Committee, you should not accept appointment thereto.

The City of Edinburgh Council

The Pensions Committee

Lothian Pension Funds Consultative Panel

UNDERTAKING

For signing by members of the Pensions Committee and the Lothian Pension Funds Consultative Panel

<u>Code of Conduct</u>

I hereby;

(i) acknowledge that I have read and understood the Pensions Committee “Code of Conduct” and

(ii) undertake to comply with the said Code of Conduct.

<u>Confidentiality</u>

I hereby;

(i) acknowledge that, as a member of the Pensions Committee/Lothian Pension Funds Consultative Panel, I am given access to documents of which are of a confidential nature;

(ii) undertake not to disclose any such document (or any information contained within any such document) to any other party without the prior written permission of the City of Edinburgh Council’s Director of Corporate Governance;

(iii) agree to take all reasonable steps to prevent such disclosure; and

(iv) accept that the confidentiality obligations of this undertaking continue even after I cease to be a member of the Pensions Committee/Lothian Pension Funds Consultative Panel.

Signature: …………………………………………..

Name (Block Capitals): …………………………………………..

Post/Job Title: …………………………………………..

Date of signing: …………………………………………..

Pensions Committee

2pm, Tuesday, 18 December 2012

Annual Report on the 2011/12 Audit of the Lothian Pension Funds

Item number	5.2
Report number	
Wards	All

Links

Coalition pledges	
Council outcomes	CO26
Single Outcome Agreement	

Alastair MacLean

Director of Corporate Governance

Contact: John Burns, Pensions & Accounting Manager

E-mail: john.burns@edinburgh.gov.uk | Tel: 0131 469 3711

EDINBVRGH
THE CITY OF EDINBURGH COUNCIL

Executive summary

Annual Report on the 2011/12 Audit of the Lothian Pension Funds

Summary

The purpose of this report is to present the Auditor's Annual Report on the 2011/12 Audit of the Lothian Pension Funds. The report from Audit Scotland is shown at Appendix 1. This includes commentary from the Investment & Pensions Manager as to planned management actions. The report will be presented to the Pensions Committee by Jim Rundell, Senior Manager, Audit Scotland.

In addition to members of the Pensions Committee, Audit Scotland has also sent the report to the Controller of Audit and has advised that the report will be published on its web-site in due course.

Audit Scotland has already provided "an unqualified opinion that the financial statements (of the Lothian Pension Funds) give a true and fair view of the transactions of the funds during the year ended 31 March 2012, and of the amount and disposition at that date of their assets and liabilities".

Recommendations

To recommend that the Pensions Committee should:-

1. note the Annual Report on the 2011/12 Audit of the Lothian Pension Funds;
2. note the Action Plan at Appendix B of the Report and seek appropriate updates on progress.

Measures of success

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

Financial impact

There are no financial implications arising directly from this report.

Equalities impact

There are no adverse equalities impacts arising from this report.

Sustainability impact

There are no adverse sustainability impacts arising from this report.

Consultation and engagement

As an integral part of governance, the Consultative Panel for the Lothian Pension Funds comprises employer and member representatives. The Panel members attend Pension Committee meetings, ten in a non-voting capacity and two with full voting rights.

Background reading / external references

Not applicable.’

Links

Coalition pledges	
Council outcomes	CO26 – The Council engages with stakeholders and works in partnerships to improve services and deliver agreed objectives.
Single Outcome Agreement	
Appendices	Appendix 1 – Cover letter from Audit Scotland linked to Appendix 2 Appendix 2 – Audit Scotland report on 2011/12 Audit of Lothian Pension Funds

Address:
7th Floor, Plaza Tower
East Kilbride G74 1LW

Telephone:
0845 146 1010

Website:
www.audit-scotland.gov.uk

Email:
info@audit-scotland.gov.uk

Alastair MacLean
Director of Corporate Governance
City of Edinburgh Council
Waverly Court
4 East Market Street
Edinburgh
EH8 8BG

31 October 2012

Dear Alastair

Lothian Pension Funds
Report to Members and the Controller of Audit on the 2011/12 Audit

Following agreement to the draft version of the final report on the 2011/12 audit, I now enclose, for your records, a final version of the report.

In accordance with agreed procedures a copy of the report has also been sent to our Best Value and Scrutiny Improvement Group in Edinburgh. A copy of the report will be published on Audit Scotland's website in due course.

I would like to thank all staff contacted during the course of the audit for their assistance and co-operation.

Yours sincerely

[redacted]

David McConnell
Assistant Director

By email: Sue Bruce, Chief Executive
Clare Scott, Investment & Pensions Service Manager
John Burns, Accounting and Pensions Manager
Sharon Middlemass, Best Value & Scrutiny Improvement Group, Audit Scotland

Lothian Pension Funds

Annual report on the 2011/12 audit

AUDIT SCOTLAND

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

October 2012

Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000. It provides services to the Auditor General for Scotland and the Accounts Commission. Together they ensure that the Scottish Government and public sector bodies in Scotland are held to account for the proper, efficient and effective use of public funds.

Contents

Key messages

2011/12 audit findings

Lothian Pension Funds (the Funds) comprise three funds within the Local Government Pension Scheme: the Lothian Pension Fund; the Lothian Buses Pension Fund for employees of Lothian Buses plc which is now closed to new members and Scottish Homes Pension Fund, covering their former employees.

During 2011/12 we looked at the key strategic and financial risks faced by Lothian Pension Funds. We audited the financial statements and looked at aspects of governance, use of resources and performance. This report sets out our main findings, summarising key outcomes from the 2011/12 audit and the outlook for the period ahead.

We have given an unqualified opinion that the financial statements give a true and fair view of the transactions of the funds during the year ended 31 March 2012, and of the amount and disposition at that date of their assets and liabilities.

As the administering authority, City of Edinburgh Council has statutory responsibility for the administration of the Funds with responsibility for the overall strategic direction of the funds delegated to the Pensions and Trusts Committee (the committee). The remit of the committee has been changed and it is now referred to as the Pensions Committee.

Triennial funding valuations were carried out by the Funds' actuary as at March 2011. The valuation established the extent to which, based on future assumptions, a Fund's assets meet its liabilities and concluded that the main Lothian Pension Fund was 96% funded, an improvement on the 2008 funding level of 85%. The results of the triennial valuation determines employer contribution rates required over the next three year period to attain the objective of a fully funded scheme at a set future date. No change in employer contribution rates was required. The funding levels for the other Funds were: Lothian Buses - 112% funded, up from 95% in 2008; and Scottish Homes - 86% funded at both valuations.

However, one year later, the funding levels have deteriorated due to lower real bond yields and lower asset returns than expected.

At 31 March 2012 the Lothian Pension Fund had net assets of £3.581 billion (31/03/11-£3.476 billion) and in excess of 100 scheduled and admitted bodies. Investment performance, risk and activity are reported to the Investment Strategy Panel on a quarterly basis. At the year end, an annual report on investment performance and activity is produced and reported to committee. During 2011/12 Lothian Pension Fund achieved an annual return of 2.3% against its scheme specific benchmark of 2.7%. Lothian Buses Fund achieved an annual return of 5.0% against its scheme specific benchmark of 4.5%. Scottish Homes Fund achieved an annual return of 12.7% against a benchmark of 12.6%.

The Funds' Pension Administration Strategy for was approved by the committee in March 2010. It contains the standards which are required of the participating employers and the Funds to ensure that the Funds meet their statutory obligations and are able to deliver services efficiently. The strategy contains a variety of performance measures against which the Funds and the participating employers are assessed with performance being reported to the committee. Administration performance of the Funds was satisfactory but that of employers has been disappointing in 2011/12 and discussions are ongoing with employers to determine ways to improve performance.

Outlook

These are challenging times for pension fund management.

With the global economic outlook and the uncertainty in the financial markets there are particular problems for investment management and strategy. With investment performance key to the funding position of the Local Government Pension Scheme (LGPS) this uncertainty may impact on employer contributions in the medium term.

It is against this backdrop, and at a time of continued austerity in the public sector, that the new Public Service Pensions Bill has been published. The bill signals more changes ahead for the LGPS, with some changes aimed at reducing costs, and others at setting a common legislative framework and improving governance arrangements.

Proposed changes to the LGPS will impact on administrative workloads going forward as will any further severance activity by employers. Additionally auto enrolment requirements affect information requirements and administration arrangements.

An Administration Strategy was implemented for the first time in 2010/11. This sets out the standards required of participating employers to enable the efficient administration of the pension fund. The report to the Pensions and Trusts Committee on the Strategy in June 2012 indicated that performance in a number of areas fell short of the targets required. Meetings have been, and will continue to be, held with employers to discuss ways to improve performance and the transfer of data to Lothian Pension Fund. Management expect that the introduction of a new Employer on-line system in 2013 will also help to improve performance.

The co-operation and assistance given to us by members of the Pension & Trusts Committee, officers and staff of the Investment and Pensions Division is gratefully acknowledged.

Introduction

1. This report is the summary of our findings arising from the 2011/12 audit of Lothian Pension Funds. The nature and scope of the audit were outlined in the Audit Plan presented to the Pensions and Trusts Committee on 28 March 2012, and follow the requirements of the Code of Audit Practice prepared by Audit Scotland in May 2011. The purpose of the annual audit report is to summarise the auditor's opinions (i.e. on the financial statements) and conclusions, and to report any significant issues arising. The report is divided into sections which reflect the public sector audit model.

2. A number of reports have been issued in the course of the year in which we make recommendations for improvements (Appendix A). We do not repeat all of the findings in this report, but instead we focus on the financial statements and any significant findings from our wider review of the administering authority's arrangements for the management of the fund.

3. Appendix B is an action plan setting out the high level risks we have identified from the audit. Officers have considered the issues and agreed to take the specific steps in the column headed "planned management action". We do not expect all risks to be eliminated or even minimised. What we expect is that those charged with governance understand the risks and have arrangements in place to manage these risks. The Funds should ensure that those charged with governance are satisfied with the proposed management action and have a mechanism in place to assess progress.

4. This report is addressed to City of Edinburgh Council as administering body for Lothian Pension Funds and the Controller of Audit and should form a key part of discussions with the Pensions Committee, either prior to, or as soon as possible after, the formal completion of the audit of the financial statements. Reports should be available to the Scottish Parliament, other stakeholders and the public, where appropriate. Audit is an essential element of accountability and the process of public reporting.

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

6. The management of Lothian Pension Funds is responsible for preparing financial statements that show a true and fair view and for implementing appropriate internal control systems. Weaknesses or risks identified by auditors are only those which have come to their attention during their normal audit work, and may not be all that exist. Communication by auditors of matters arising from the audit of the financial statements or of risks or weaknesses does not absolve management from its responsibility to address the issues raised and to maintain an adequate system of control.

Financial statements

7. Audited bodies' financial statements are an essential part of accounting for their stewardship of the resources made available to them and their performance in the use of those resources.

8. Auditors are required to audit financial statements in accordance with the timescales set by Audit Scotland, which may be shorter than statutory requirements, and give an opinion on:
   - whether they give a true and fair view of the financial transactions of the Funds during the year ended 31 March 2012 and of the amount and disposition at that date of its assets and liabilities
   - whether they have been properly prepared in accordance with relevant legislation, the applicable accounting framework and other reporting requirements.

9. Auditors review and report on, as appropriate, other information published with the financial statements, including the foreword by the Director of Corporate Governance, the annual governance statement and the governance compliance statement. This section summarises the results of our audit on the financial statements.

Audit opinion

10. We have given an unqualified opinion that the financial statements of Lothian Pension Funds for 2011/12 give a true and fair view of the financial transactions of the Funds during the year ended 31 March 2012 and of the amount and disposition at that date of its assets and liabilities.

Legality

11. Through our planned audit work we consider the legality of the pension fund's financial transactions. In addition the Pensions and Accounting Manager has confirmed that, to the best of his knowledge and belief, the financial transactions of the pension fund were in accordance with relevant legislation and regulations. There are no legality issues arising from our audit which require to be brought to the attention of those charged with governance.

Annual Governance statement

12. An Annual Governance Statement has been included in the Funds' annual report; the Code of Practice on Local Authority Accounting in the UK (the Code) does not require this statement to be provided, so the funds have demonstrated good practice by its inclusion. This statement provides a high level overview of the governance arrangements that are in place, what internal controls the funds place reliance on, and a review of their effectiveness. We are satisfied by the disclosures in the Annual Governance Statement.

Governance compliance statement

13. Regulation 27 of the Local Government Pension Schemes (Administration) (Scotland) Regulations 2008 (SSI 2008/228) requires that the administering authority prepare a governance compliance statement stating where their arrangements complied with Scottish Ministers Guidance, and where they did not. Although the regulations allow for this statement to be referred to in the annual report, the funds took the decision to include the full statement.

Annual Report

14. The Scottish Government Guidance requires that the annual report for the pension fund incorporates the following:
    - the financial statements
    - a report about the management and financial performance of the funds during the year
    - a report explaining the authority's investment policy and reviewing the performance during the year of the investments of each fund, and a report of the arrangements made during the year for the administration of the funds
    - a statement by the actuary of the level of funding disclosed by their valuation
    - a governance compliance statement, funding strategy statement, and statement of investment principles (or details of where these statements may be obtained)
    - the extent to which levels of performance set out in the pension administration strategy have been achieved
    - any other material which the authority considers appropriate.
15. We are satisfied that the report complies with Scottish Government guidance and that the other sections are consistent with the audited accounts.

Accounting issues

16. Local authority bodies in Scotland are required to follow the 2011/12 Code of Practice on Local Authority Accounting in the United Kingdom (the 2011/12 Code). Further guidance was issued for 2011/12, requiring more detailed disclosure in the annual accounts. We were satisfied that the financial statements have been prepared in accordance with the 2011/12 Code.

Accounts submission

17. The fund's unaudited financial statements were submitted to the Controller of Audit by the deadline of 30 June 2012. This enabled us to conclude the audit and certify the financial statements by the target date of 30 September 2012.

Presentational and monetary adjustments to the unaudited accounts

18. In line with International Standards on Auditing 260 *Communication of audit matters to those charged with governance*, we reported the conclusions of our audit to the Audit Committee on 27 September 2012. Two errors were identified during the audit. One error relating to the accrual of death benefits was not considered to be material and was unadjusted while the other error relating to an historic over valuation of one private equity limited partnership was amended in the signed financial statements.

Financial position

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

20. Auditors consider whether audited bodies have established adequate arrangements and examine:

- financial performance in the period under audit
- compliance with any statutory financial requirements and financial targets
- ability to meet known or contingent, statutory and other financial obligations
- responses to developments which may have an impact on the financial position
- financial plans for future periods.

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

Financial results

Budgetary control

22. The Funds' actual expenditure compared to the budget disclosed an underspend of £2,350,000 for the year to 31 March 2012. The main areas of underspend were supplies and services (£134,000), investment managers fees (£1,883,000) and central support costs (£77,000).

23. Investment manager's fees are dependant on market values and on a performance element for some managers. The main performance related saving arose in respect of Lothian Buses Pension Fund (£561,000). A further saving of £1,370,000 arose as a result of two external fund managers not being used for part of the year.

Financial position

24. In accordance with accounting standard IAS 26 'Accounting and Reporting by Retirement Benefit Plans' the actuarial present value of proposed retirement benefits (actuarial value) is disclosed by way of a note to the pension funds financial statements. Employer bodies are required to recognise their share of the net liabilities for the pension fund in their balance sheets. Exhibit 1 sets out the net assets for each of the funds and compares them with the actuarial value of the retirement benefits to produce a net asset/liability position. The figures are only prepared for the purposes of IAS 26 and are not relevant for calculations undertaken for funding purposes and setting contributions payable to the Fund.

Exhibit 1: Financial position of the funds at 31 March 2012 (IAS 26 basis)

Description	Net Assets £m	PV of promised retirement benefits £ m	Net asset/(liability) £m
Lothian Pension Fund	3581	4185	(604)
Lothian Buses Fund	271	269	2
Scottish Homes Fund	131	131	0
Total	**3983**	**4585**	**(602)**

Source: Financial Statements

25. The Lothian Pension Fund discloses a deficit position. In calculating the actuarial value for accounting purposes, the long term view of the fund in meeting its future commitments is considered having taken employers' contribution rates and revenues generated from investments into account.

26. The triennial valuation of the three funds was completed at 31 March 2011. The results of the valuation are disclosed in Exhibit 2. The valuation discloses that Lothian Pensions Fund actual funding level rose from 85% at the 2008 valuation to 96% at 2011. Lothian Buses Pension Fund funding level rose from 95.5% to 112.4% and Scottish Homes Pension Fund showed a slight increase from 85.9% to 86.3%. Although funding levels had increased over the three year inter-valuation period the funding levels at 31 March 2012 have reduced due to lower bond levels and lower asset returns than expected.

Exhibit 2: Funding levels at triennial valuation 31 March 2011

Description	Market value of assets £ million	Past Service liabilities £ million	Funding level
Lothian Pension Fund	3,477	3,619	96%
Lothian Buses Fund	257	229	112.4%
Scottish Homes Fund	124	144	86.3%

Source: Triennial Valuation 2011

27. During the year overall membership of the Lothian Pension Fund increased from 65,713 to 66,354. Active members, however, decreased by 582 and pensioners increased by 1,011. This continues the trend from recent years. The total number of members retiring was 1,310 of which 607 (2010/11-622) related to members retiring as a result of employers offering Voluntary Early Release Arrangements (VERA). This trend in early retirements is likely to

continue for the next few years. However, the Lothian Pension Fund may see increased membership due to auto enrolment.

28. The Funds have recognised the significant impact of the early release programmes in the Funding Strategy Statement which states that "the Fund shall undertake a regular review of its investment strategy to ensure appropriate alignment with its liabilities. Employer covenant and membership maturity profile reflecting any decision to close the Scheme to new entrants are both risk factors which may impact on liabilities and therefore will be taken into account by the Fund in its review of investment strategy."

29. The Funds are liaising with Hymans Robertson to explore the feasibility of developing a financial model to provide greater insight into cashflow forecasting as the Lothian Pension Fund is expected to move from net positive cashflows from dealings with members to a negative position. As Fund maturity increases, investment income will be required to be used to pay pension benefits. Based on current projections eventually the drawdown of investment assets will be required although the Fund's actuary has advised that this not likely to happen in the short term.

30. Cashflow monitoring reports are prepared monthly to ensure that sufficient cash balances are held to meet ongoing pension commitments, and that any excess balances are passed periodically to the fund's investment portfolios. These cashflow reports are submitted to management but are not submitted to the Pensions and Trusts committee.

Refer Action Plan no. 1

Outlook

2012/13 budget

31. The 2012/13 annual budget for administration costs is £13.299 million, an increase of £0.429 million from 2011/12. The most significant increases are investment managers (£0.481 million), custody fees (£0.139 million) and employee costs (£0.100 million) offset by increased income from securities lending of £0.300 million.

32. The most recent administration budget monitoring report to committee, as at period 4 in 2012/13, showed an underspend of £0.154 million.

Financial forecasts beyond 2012/13

33. As a result of widespread severance schemes and recruitment freezes across participating employer bodies, it is likely that the membership profile of the fund will increasingly have a higher proportion of pensioner members compared to active members. At some point in the future this will result in monthly income not being sufficient to meet the fund's monthly commitments, requiring the use of investment income to pay pension benefits. This has been considered as part of the Fund's review of its Investment strategy highlighted in paragraph 28.

Refer Action Plan no. 2

34. Looking ahead, it is clear that the outlook for public spending for the period 2013/14 to 2015/16 remains very challenging. There are a number of ongoing developments in the public sector pension environment that could have a significant impact on the operation of local government pension schemes.

Governance and accountability

35. The three fundamental principles of corporate governance – openness, integrity and accountability – apply to all audited bodies, whether their members are elected or appointed, or whether they comprise groups of people or an individual accountable officer.

36. Through its chief executive or accountable officer, each body is responsible for establishing arrangements for ensuring the proper conduct of its affairs including the legality of activities and transactions, and for monitoring the adequacy and effectiveness of these arrangements. Audited bodies usually involve those charged with governance (including audit committees or similar groups) in monitoring these arrangements.

37. Through its chief executive or accountable officer, each body is responsible for establishing arrangements for ensuring the proper conduct of its affairs including the legality of activities and transactions, and for monitoring the adequacy and effectiveness of these arrangements. Audited bodies usually involve those charged with governance (including audit committees or similar groups) in monitoring these arrangements.

38. Consistent with the wider scope of public audit, auditors have a responsibility to review and report on audited bodies' corporate governance arrangements as they relate to:

- corporate governance and systems of internal control
- the prevention and detection of fraud and irregularity
- standards of conduct and arrangements for the prevention and detection of corruption.

39. In this part of the report we comment on key areas of governance.

Corporate governance

Processes and committees

As the administering authority, City of Edinburgh Council has statutory responsibility for the administration of the funds. Its functions are carried out in accordance with the Local Government Pension Scheme (Scotland) Regulations 1998 and the Superannuation Act 1972.

40. During the year the committee meets quarterly to consider pension fund matters including reports on investment monitoring, budget monitoring and service plans. The committee's current membership consists of five councillors with a quorum of two. We observed that 4 members were present at the committee on three occasions and 3 attended the other meeting.

41. Day to day administration of the fund is carried out by the Investment and Pensions Division which is a division of the council's Corporate Governance department. The Pensions and Accounting Manager was appointed as the S95 Officer at the Policy and Strategy Committee on 28 February 2012.

42. There was a new requirement in 2011/12 for pension funds to produce a governance compliance statement, setting out areas where it does and does not comply with guidance issued by the Scottish Government on committee governance arrangements. The guidance covers membership of the pension committee, frequency of meetings, training of members and several other areas. The governance compliance statement produced by the funds meets the requirements of this guidance.

43. Given the complex nature of pensions and investments, it is important that the committee receive continuous training and support to enable effective scrutiny. There are likely to be many legislative and regulatory changes over the coming years, so it is essential that members receive sufficient training to keep them up to date with current events. This is particularly important for those members who are new to the committee as a result of the Scottish local government elections in May 2012.

Internal Audit

44. Internal Audit holds a key role in the authority's governance arrangements, providing an independent appraisal service to management by reviewing and evaluating the effectiveness of the internal control system. The Fund's internal audit service is provided by the City of Edinburgh's internal audit section. Our review of internal audit was conducted as part of the audit of the City of Edinburgh Council. The review found that the work is conducted in accordance with CIPFA's Code of Practice for Internal Audit in Local Government.

45. In terms of International Standard on Auditing 610 (Considering the work of internal audit), we placed formal reliance on internal audit's testing in relation to employer and employee contributions, lump sums and pension payments and on their review of pension fund investments.

46. The council's internal audit service is going through a period of transition. The Chief Internal Auditor retired at the end of July 2012 and a manager from PricewaterhouseCoopers was appointed to manage the service on an interim basis. At the end of September 2012 a further six internal auditors retired.

47. Tenders have been issued for the provision of an internal audit service with two options being proposed - full outsourcing or co-sourcing. Tenders were returned on 10 October 2012 and are due to be evaluated on 22 October 2012. The outcome of this exercise will determine the future shape of the internal audit function. Until then internal audit will be running below full strength and this will impact on the amount of work that can be carried out. There is a risk that the internal service will not be able to deliver on its plans in respect of Lothian Pension Funds.

Refer Action Plan no. 3

Internal control

While auditors concentrate on significant systems and key controls in support of the opinion on the financial statements, their wider responsibilities require them to consider the financial systems and controls of audited bodies as a whole. However, the extent of this work should also be informed by their assessment of risk and the activities of internal audit.

48. The fund's financial systems run alongside those of the City of Edinburgh Council and its financial ledger and payroll system are used to process transactions. There are specific systems and lines of responsibility for pension administration and for investment transactions.

49. No material weaknesses in the accounting and internal controls systems were identified in the Investments and Pensions Division during our audit.

50. As part of our work, we took assurance from key controls within the fund's systems, with some controls being tested by internal audit. A follow up report detailing progress on the risks identified in the 2010/11 annual audit report was submitted to management in June 2012. No significant control weaknesses were identified during this work.

Prevention and detection of fraud and irregularities

51. Audited bodies are responsible for establishing arrangements to prevent and detect fraud and other irregularity. Auditors review and report on these arrangements.

52. The Funds have arrangements in place to prevent and detect fraud, corruption and inappropriate conduct. These arrangements include standing orders and financial regulations, a whistle blowing policy, an anti-fraud and corruption policy and codes of conduct for elected members and staff. We are pleased to note that the Funds continue to have appropriate arrangements in place to minimise the risk of fraud and corruption.

NFI in Scotland

53. Audit Scotland has co-ordinated another major counter-fraud exercise working together with a range of Scottish public bodies, external auditors and the Audit Commission to identify fraud and error. These exercises, known as the National Fraud Initiative in Scotland (NFI), are undertaken every two years as part of the statutory audits of the participating bodies. The latest exercise started in October 2010 and was reported upon in May 2012. The next round of NFI is due to commence in June 2012, and will look to expand the range of data sets and bodies.

54. The NFI works by using data matching to compare a range of information held on bodies' systems to identify potential inconsistencies or circumstances that could indicate fraud or error which are called 'matches'. Where matches are identified these are made available to bodies to investigate via a secure web application. Bodies investigate these and record appropriate outcomes based on their investigations.

55. As part of our local audit work we monitor the council's approach to participation in NFI both in terms of the submission of the required datasets and strategies for investigating the

subsequent data matches. With regard to pensions, there were 521 matches that identify people who are in receipt of pension but also appear on DWP and registrars records as being deceased, or who appear on another payroll system. 38 cases were identified with a value of £45,996 of which £23,896 has been recovered.

Standards of conduct and arrangements for the prevention/ detection of bribery and corruption

56. Audited bodies are responsible for ensuring that their affairs are managed in accordance with proper standards of conduct and have proper arrangements in place for implementing and monitoring compliance with standards and codes of conduct, standing orders and financial instructions. Auditors consider whether bodies have adequate arrangements in place. We have concluded that the arrangements in Lothian Pension Funds are satisfactory and we are not aware of any specific issues that we need to identify in this report.

Outlook

57. Responsibility for the overall strategic direction of the fund is delegated by the council to the Pensions and Trusts Committee (the committee) which in 2011/12 was comprised of elected members of the council. The Director of Corporate Governance submitted a report to the committee in June 2012 setting out proposals for the review of pension governance. The main changes are as follows:

- removal of the governance of charitable trusts from the committee
- an increase in the membership of the committee from 5 to 7 including 2 non City of Edinburgh stakeholders selected from the Consultative Panel to represent employers and members
- establishment of an Audit Sub-Committee of the Pensions Committee
- reduction of the number of members of the Lothian Pensions' Fund Consultative Panel.

58. Management anticipate that the new governance arrangements as highlighted in paragraph 57 above will improve scrutiny of the pension funds and encourage stakeholder participation. We will monitor developments in this area including any post-implementation review to assess their effectiveness.

59. These proposals were accepted by City of Edinburgh Council on 20 September 2012.

60. A number of measures will be introduced in 2012/13 as part of the Pensions Act 2011. This act is part of the legislation passed by government aimed at reforming workplace pensions and encouraging individuals to save for their retirement. One key provision of the act is auto enrolment. The requirement is that all employers must make arrangements to ensure that their eligible jobholders become active members of an auto enrolment pension scheme from their auto enrolment staging date. This provision directly impacts on the Local Government Pension Scheme, and the administration section of the fund.

61. Prior to this requirement being implemented, the Fund has conducted a review to assess the employers' preparations for the introduction of auto enrolment. It was found that good progress has been made but a substantial amount of work is still needed by employers in preparation for auto enrolment.

62. The future shape of LGPS in Scotland remains uncertain. However, it is likely that proposed changes will impact on administrative workloads going forward. We will continue to monitor the fund's arrangements in preparing for these changes and any potential risks that arise.

Best Value, use of resources and performance

63. Audited bodies have a specific responsibility to ensure that arrangements have been made to secure Best Value.

64. Auditors of local government bodies also have a responsibility to review and report on the arrangements that specified audited bodies have made to prepare and publish performance information in accordance with directions issued by the Accounts Commission.

65. As part of their statutory responsibilities, the Accounts Commission may procure, through Audit Scotland, examinations of the use of resources by audited bodies and publish reports or guidance. Auditors may be requested from time to time to participate in:

- a performance audit which may result in the publication of a national report
- an examination of the implications of a particular topic or performance audit for an audited body at local level
- a review of a body's response to national recommendations.

66. Auditors may also consider the use of resources in services or functions, where the need for this is identified through local audit risk assessments.

67. During the course of their audit appointment auditors should also consider and report on progress made by audited bodies in implementing the recommendations arising from reviews in earlier years.

68. This section includes a commentary on the Best Value and performance management arrangements within the pension fund. We also note any headline performance outcomes/ measures used by the members and any comment on any relevant national reports and the body's response to these.

Management arrangements

Best Value

69. The pension fund has not been subject to a Best Value review however, it is covered by the overall Best Value arrangements of the administering authority.

Investment Performance

70. Investment advice and support is provided to the fund by its Investment Strategy Panel (ISP) which is comprised of investment advisers and senior officers. The role of the ISP includes the development of investment strategy and the monitoring of the Funds' investments.

71. At the year end, an annual report on overall investment performance and activity is produced and reported to committee. The main performance issues arising from the report are described in paragraphs 73 to 79.

72. To ensure value for money is obtained the Funds carry out a structured procurement process which includes the consideration of fees. In addition the managers are monitored and their performance discussed at regular meetings. The results of the monitoring are reported to the Investment Strategy Panel.

Lothian Pension Fund

73. During 2011/12 the fund achieved an annual return of 2.3% against its scheme specific benchmark of 2.7%. This underperformance has resulted in the main from poor returns from four managers in 2011/12. Of the fund's 8 investment managers, 5 underperformed against the benchmarks applied to them in 2011/12.

74. The fund achieved a 10 year annualised return of 6.2% against the benchmark of 5.3%.

75. The global equity mandate managed by one manager was terminated in December 2011 and assets were managed internally on an interim basis in preparation for the appointment of new global equity managers following an EU tender process. The tender process concluded with six global equity managers being appointed to a framework arrangement.

Lothian Buses Pension Fund

76. During 2011/12 the fund achieved an annual return of 5% against its scheme specific benchmark of 4.5% as a result of a strong performance in property investment.

77. The fund achieved a 10 year annualised return of 7.4% which is above the benchmark of 6.5%.

Scottish Homes Pension Fund

78. During 2011/12 the fund achieved an annual return of 12.7% against its scheme specific benchmark of 12.6%.

79. The fund achieved an annualised return since its inception in July 2005 of 8.2% against the benchmark of 8.3%.

Administration Performance

80. The Funds' Administration Strategy was approved by the Pensions and Trusts Committee in March 2010. It contains the standards which are required of the participating employers to ensure that the fund meets its statutory obligations and is able to deliver services efficiently. The strategy contains a variety of performance measures against which the fund and the participating employers are assessed.

81. In accordance with Regulation 60A of the LGPS (Administration) (Scotland) Regulations 2008, the fund's annual report discloses performance against the measures detailed in the Pension Administration Strategy.

82. Proposed changes to the LGPS will impact on administrative workloads going forward as will any further severance activity by employers. Additionally auto enrolment begins for some employers in 2012/13 and this will also affect information requirements and administration arrangements. There is a risk that the increased workload will increase pressure on staff and key tasks and statutory requirements will not be delivered.

Refer Action Plan no. 4

Employers' Performance

83. Administration performance in relation to employers has been disappointing in 2011/12 with none of the five targets being achieved. Retirement notification within 20 days of retiral only achieved 39% of target whilst notification of death in service within ten days only achieved 30% of target.

Refer Action Plan no. 5

84. In relation to its own performance the Fund exceeded or matched its target in four out of five categories with the exception being leavers where only 38% of target was achieved.

85. Following a competitive procurement, the Fund has now invested in an Employer On-line Portal for pension administration. This ICT enhancement provides the opportunity for transformational change in data transfer between employers and the Fund and therefore has the potential to provide radical improvement.

86. The Pension Administration Strategy (PAS) has been reviewed for the year 2012/13 and was strengthened in June 2012 by the addition of a Compliance Certificate. The Compliance Certificate is intended to formalise each employer's responsibility under the PAS. The document requires one senior manager from each employer to certify that that the employer understands and will undertake its various obligations under the Local Government Pension Scheme regulations.

User engagement

87. There is regular communication with employers, members and pensioners with regard to the funds involving seminars, briefings, leaflets, newsletters and the website which is regularly updated.

88. The Consultative Panel (the Panel) is the main mechanism for engagement with the Fund's stakeholders and enables their involvement in the decision-making process. The Panel meets jointly with the committee.

89. Regular customer surveys are carried out for the funds and the results are included in the annual report. Overall 84% of respondents agreed that the service provided was excellent.

90. Members now have electronic access to their benefit statements.

National performance reports

91. Audit Scotland carries out a national performance audit programme on behalf of the Accounts Commission and the Auditor General for Scotland. Reports in the last year which may be of interest to members and officers are detailed in Exhibit 3 below.

Exhibit 3: A selection of National performance reports 2011/12

- An overview of local government in Scotland - challenges and change in 2012
- Managing performance: are you getting it right
- Scotland's Public Finances-Addressing the Challenges
- The National Fraud Initiative in Scotland
- How Councils work: using cost information to improve performance

Source: www.audit-scotland.gov.uk

92. We suggest that officers review national performance reports as they become available and consider any findings which may impact on the pension fund.

Outlook

93. Continuing to meet performance targets will become more challenging in the coming years. Investment targets are set based on advice from investment advisors and standard industry benchmarks. The funds will have to remain vigilant, and ensure that they have the right diversification of funds to minimise exposure to risk whilst still delivering the required returns.

94. Improvements that are being made to the pension administration system, and the way in which data is received, should improve performance going forward, although this is dependent on the provision of information timeously by scheduled and admitted bodies.

95. Increased workloads may affect staff morale and it is important that the funds monitor workloads and plan accordingly.

Appendix A: audit reports

External audit reports and audit opinions issued for 2011/12

Title of report or opinion	Date of issue	Date presented to Audit Committee
Annual Audit Plan	13 February 2012	28 March 2012
Governance follow-up report.	28 June 2012	27 June 2012
Report on financial statements to those charged with governance (ISA 260)	14 September 2012	27 September 2012
Audit opinion on the 2011/12 financial statements	14 September 2012 *	27 September 2012
Report to Members on the 2011/12 audit	31 October 2012	6 December 2012

* **Proposed audit opinion issued on 14 September and formally signed on 28 September following the Audit Committee of 27 September.**

Appendix B: action plan

Key Risk Areas and Planned Management Action

Action Point	Refer Para No	Risk Identified	Planned Management Action	Responsible Officer	Target Date
1	30	Cashflow reports are submitted to management but are not submitted to the Pensions and Trusts committee for review. ***Risk: Committee Members do not have the opportunity to scrutinise cash flow reports and address any issues identified by them.***	Management monitor short-term (monthly) cashflow to ensure there is sufficient cash to pay benefits and to ensure excess cash can be invested as soon as practical. Short term cashflow can fluctuate significantly. The Investment Strategy Panel considers medium-term (up to 2 year) cashflow projections on a quarterly basis. Long-term cashflow, including projection, is reported to Committee as part of funding and investment strategy reviews as well as part of the annual accounts e.g. December 2010 (Contribution Stability Mechanism) and October 2012 (Investment Strategy Review). Additional monitoring of investment income and membership numbers is being put in place following the adoption of the revised investment strategies. Consideration will be given to the appropriate cashflow monitoring process.	Investments & Pensions Service Manager	March 2013

Action Point	Refer Para No	Risk Identified	Planned Management Action	Responsible Officer	Target Date
2	33	The changing profile of the funds' membership may result in monthly income not being sufficient to meet the fund's monthly commitments, requiring the use of investment income to pay pension benefits. **Risk:** ***Financial plans prepared by the pension funds are not achieved.***	Reviews and financial plans of the Fund are, and will continue to, be reviewed regularly. They do, and will, take into account membership profile and potential changes. The comments at Action point 1 are relevant in this context. In addition at the 2011 actuarial valuation the Fund ensured that the recovery of any past service deficit is achieved irrespective of any fluctuations in future payroll by expressing contributions for the recovery of deficits from 2012/13 as a fixed monetary amount. Also, the Fund will now consider requests from employers for a lower risk investment strategy to take into account changing membership profiles. It also should be stated that the a significant majority of members of the Local Government Pension Scheme are from employers with strong covenants, i.e. Scheduled Bodies, such as local authorities, which also must remain open to new entrants. Appropriate guarantors of pension liabilities are always sought prior to admission. Financial risk exposure to Lothian Pension Fund should therefore be viewed in this context.	Investments & Pensions Service Manager	Ongoing

Action Point	Refer Para No	Risk Identified	Planned Management Action	Responsible Officer	Target Date
3	47	The internal audit function is running below full strength and this could impact on the amount of work that can be carried out in relation to the 2012/13 financial year. **Risk: *The internal audit function may not be able to deliver on its planned programme of work in 2012/13*.**	The Internal Audit Plan 2012/13 (i.e. October 2012 to September 2013) was considered by Audit Committee on 27/9/12. The proposed activity for the Funds was a "Review of Quality Assurance Framework", which was allocated 40 (auditor work) days. As is stated, options for the future delivery of the Internal Audit service are being evaluated currently by the Council. The Funds will commission supplementary audit services for 2012/13. Discussions with Audit Scotland and the Acting Chief Internal Auditor are already underway.	Investments & Pensions Service Manager	December 2013
4	82	Proposed changes to the LGPS will impact on administrative workloads going forward as will any further severance activity by employers. Additionally auto enrolment begins for some employers in 2012/13 and this will also affect information requirements and administration arrangements. ***Risk: The increased workload will increase pressure on staff and key tasks and statutory requirements will not be delivered.***	It is recognised that impending reform of the LGPS in Scotland is likely to increase significantly the burden of pension administration. There is certainly some degree of risk exposure for Lothian Pension Fund from both the perspective of key staff expertise and also ICT system supplier readiness. That said, Lothian Pension Fund has included additional resource in its budget from 2012/13 in anticipation of changes and is already focusing on enhancements both to operational efficiency and to data quality. Specifically, data quality	Investment and Pensions Service Manager	Ongoing

Action Point	Refer Para No	Risk Identified	Planned Management Action	Responsible Officer	Target Date
			improvements as a result of the system enhancements to transfer data electronically from employers to the Fund ("Employer On-line") should also be most beneficial in the transition to a Career Average Revalued Earnings scheme. The need to ensure that the pension administration computing system can cope with demands of a new scheme has already been raised at the Scottish Local Government Pensions Advisory Group (SLOGPAG) forum. Appropriate and timely liaison with the system supplier, at a national level, is therefore anticipated.		
5	83	Administration performance in relation to employers has been disappointing in 2011/12 with none of the five targets being achieved. ***Risk: delays in information provision may impact on the delivery of accurate and timely services to members.***	Unfortunately, this overall poor performance from employers in the provision of information is by no means untypical across the pensions industry in both public and private sectors. Lothian Pension Fund, however, is not content with the status quo. The Investment & Pensions Service Manager has raised this as a key priority issue at face-to-face meetings with senior managers of the major employers. The forthcoming phased implementation of "Employer On-line", which prioritises the largest memberships, also represents a significant	Investment and Pensions Service Manager	Ongoing

Action Point	Refer Para No	Risk Identified	Planned Management Action	Responsible Officer	Target Date
			opportunity for employers to embrace this new technology and deliver meaningful improvements to the provision of pension record data. It should be noted also that the Pension Administration Strategy, as approved by the Pensions & Trusts Committee, includes the ultimate sanction of financial penalty on any employer failing to meet expected performance standards.		

Pensions Committee

2pm, Tuesday, 18 December 2012

Investment Benchmarks and Objectives

Item number	5.3
Report number	
Wards	All

Links

Coalition pledges	
Council outcomes	CO26
Single Outcome Agreement	

Alastair Maclean

Director of Corporate Governance

Contact: Clare Scott, Investment & Pensions Service Manager

E-mail: Clare.Scott@edinburgh.gov.uk | Tel: 0131 469 3865

Executive summary

Investment Benchmarks and Objectives

Summary

In October 2012, the Pensions & Trusts Committee agreed the revised investment strategies for the pension funds and requested clarity in relation to investment objectives.

The Investment Strategy Panel has undertaken more detailed analysis of investment income and volatility, overall fund investment objectives and the implementation of the revised strategies. In addition, the Director of Corporate Governance has reviewed the budgetary and staffing implications of the revised investment strategy.

This report provides an update and recommends the Funds' investment objectives for the new investment strategies.

Recommendations

Committee is asked to:-

1. agree the Funds' objectives as outlined in paragraph 2.5;
2. note the need for a long-term investment perspective, and continuity and consistency in the internal investment team;
3. approve the recruitment of an additional Portfolio Manager to assist with the implementation of the new investment strategies.

Measures of success

The Funds' performance will be measured against the strategic benchmark to measure the success of the new investment strategies.

Financial impact

The investment strategy has a significant impact on the investment returns of the pension funds, the funding levels and employer contribution rates. The revised investment strategies will focus on income and capital preservation, aiming to reduce the volatility of the funding level.

Equalities impact

There are no equalities impacts arising from this report.

Sustainability impact

There are no sustainability impacts arising from this report.

Consultation and engagement

Employers were consulted during the review of investment strategies.

Background reading / external references

None

Report

Investment Benchmarks and Objectives

1. Background

1.1 In October 2012, the Pensions & Trusts Committee agreed the revised investment strategies for the pension funds. Committee requested clarity in relation to investment objectives.

1.2 The Investment Strategy Panel met on 5 December to consider more detailed analysis of investment income and volatility, overall fund investment objectives and the implementation of the revised strategies. In addition, the Director of Corporate Governance has reviewed the budgetary and staffing implications of the revised investment strategies.

1.3 This report provides an update to the Committee, asks for approval of the Funds' objectives and for approval to progress with changes to staffing ahead of the budget review for 2013/14.

2. Main report

Investment Objectives

2.1 The strategy reviews concluded that the focus for the investments should be on risk, income and capital protection. In addition, the Fund should identify and utilise benchmarks other than market-cap weighted benchmarks where possible, to ensure that the objectives and risk tolerances of individual portfolios within the Fund are as closely aligned with the overall objectives of the Fund as possible.

2.2 An analysis of Lothian Pension Fund's historic income receipts was undertaken to provide perspectives. It simply showed that equity income growth has exceeded the inflation rate over the last 5 and 10 years. However, Investment Strategy Panel concluded that the analysis was not helpful in setting specific income objectives.

2.3 The Investment Strategy Panel also considered the historic volatility (risk) of the pension funds' investments. Statistical measures used to predict volatility can be unreliable and experience of risk measures suggests that specific targets for volatility would be inappropriate.

2.4 Panel felt that setting specific targets for income and/or volatility could also lead to unintended consequences, for example stretching for income yield which might result in poor income capture and/or sacrifice of total return, which will continue to be important for the Funds. While it is recommended that specific targets for income and volatility are not appropriate, a pragmatic approach will be used to manage these issues, particularly in designing investment mandates and benchmarks.

2.5 The Investment Strategy Panel have also considered the strategic benchmark for the Lothian Pension Fund and the recommend benchmark indices are set as follows:

	Strategy for 2012-17 %	**Benchmark Index**
Equities	65	Global market capitalisation weighted index
Index Linked Gilts	7	FTA Brit. Gov. I-L All Stocks
Alternatives	28	UK RPI +3.5%
TOTAL	100	

2.6 The Funds' performance will continue to be monitored and reported. It will be compared against that of the strategic benchmark.

2.7 It is recommended that the objectives of the Funds should be:

- Over long-term economic cycles (typically 5 years or more), the achievement of the same return as that generated by the strategic allocation;
- Over shorter periods, the Funds should perform better than the strategic allocation if markets fall significantly.

2.8 The investment strategy review concluded that the Fund should identify and utilise indices other than those based on market-capitalisation. The benchmark index for equities (above) is based on market capitalisation and is one of the most commonly used in the investment markets. It is felt important to retain such an index against which performance can be assessed to provide evidence of the success of the Funds' investments. However, alternative indices more suited to the Fund's objectives will be used to manage portfolios.

2.9 Measuring the Fund's performance against an index based on market capitalisation, but utilising alternative indices to manage portfolios, is expected to result in greater deviation of performance from the benchmarks in the short term for reasons other than 'traditional' manager performance. Decisions by the Investment Strategy Panel and the internal investment team (such as the choice of alternative benchmarks) will influence the Fund's return to a greater extent than previously. It will be important to ensure performance is attributed correctly.

Implementation of Strategies & Resource Implications

2.10 The Investment Strategy Panel has considered the priorities for the implementation of the new strategies and the work of the internal team. This will initially focus on the equity holdings of the Funds (particularly those which are highly constrained and based on market cap indices) and the future of the individual mandates.

2.11 As noted above, the new investment strategies mean that decisions by the Investment Strategy Panel and the internal investment team will influence the Funds' returns to a greater extent than previously. This reinforces the critical need for a long-term investment perspective as changes in investments can be costly and frequent change should be avoided. Continuity and consistency in the internal team is therefore vital. There are concerns relating to potential turnover in the team, and implications for the investments, which are being considered further. A further update will be given to Committee in 3 months.

2.12 In considering the implications of the revised investment strategy, the following conclusions are drawn:

- There are opportunities to reduce external manager fees (which make up the majority of the Funds' budget) and to focus resource on the delivery of the Funds' revised objectives. This will be explored further as work on the implementation progresses and conclusions will be reported to Committee in March 2013 as part of the budget setting for 2013/14.
- There is a need for additional resource in the Alternatives investments area, specifically in the area of Bonds, where the team lacks depth of expertise.
- Continuity and consistency in the investment team is required and potential options to address this are being considered.

3. Recommendations

3.1 Committee is asked to:-

1. agree the Funds' benchmark and objectives as outlined in paragraph 2.5 and 2.7;
2. note the need for a long-term investment perspective, and continuity and consistency in the internal investment team;
3. approve the recruitment of a Portfolio Manager to assist with the implementation of the new investment strategies.

Alastair Maclean

Director of Corporate Governance

Links

Coalition pledges	
Council outcomes	CO26 – The Council engages with stakeholders and works in partnerships to improve services and deliver agreed objectives.
Single Outcome Agreement	
Appendices	

Pensions Committee

2pm, Tuesday, 18 December 2012

Environmental Social and Governance Activity Update

Item number	5.4
Report number	
Wards	All

Links

Coalition pledges	
Council outcomes	CO26
Single Outcome Agreement	

Alastair MacLean

Director of Corporate Governance

Contact: Marlyn McConaghie, Investment Analyst

E-mail: Marlyn.McConaghie@edinburgh.gov.uk | Tel: 0131 469 3518

Executive summary

Environmental Social and Governance Activity Update

Summary

This report provides an update on the pension funds' activity on environmental, social and governance (ESG) issues which can affect the financial performance of companies in which the funds invest. The funds pursue a policy of constructive engagement on issues, which is consistent with fiduciary duties.

Voting and Engagement

The voting and engagement arrangements on the funds' direct equity holdings are shown in the tables below.

Mandate	Voting and Engagement Arrangement
Baillie Gifford (Pacific & Lothian Buses)	Baillie Gifford
Aberdeen (Emerging markets)	Aberdeen
All other listed equities	Hermes Equity Ownership Services

Details of voting and engagement activity are provided quarterly on the Funds' website. This includes both the total number of companies where the Funds have voted and details of votes against company management. The Hermes' report for the quarter to 30 September 2012 is included as Appendix 1.

Last year Committee was informed that work was underway to expand and improve the information available on the Funds' website. The website has been updated throughout the year with information on current issues, such as the Barclays Bank LIBOR fine. The main change is the inclusion of voting and engagement activity for Lothian Pension Fund's 10 largest equity holdings (Appendix 2).

Local Authority Pension Fund Forum (LAPFF)

The Lothian Pension Fund is a member of the LAPFF. LAPFF provides an opportunity for focused discussion and the sharing of ideas and working practices.

In addition to a newsletter, LAPFF now publishes a Quarterly Engagement Report (Appendix 3). The latest issue highlights LAPFF activity on Lonmin, Rolls Royce, NewsCorp and also covers the effect of accounting standards on UK banks.

Councillor Cameron Rose is currently Vice Chair of the Executive Committee of the LAPFF. Committee is asked to endorse Councillor Rose's nomination to stand for re-election to the Executive and for the position of Chair at the AGM in January 2013. If successful, Council's endorsement of the appointment will be sought. Councillor Rose will provide a verbal update to Committee on his role on the Executive.

United Nations Principles for Responsible Investment (UN PRI)

Lothian Pension Fund signed the UN PRI in 2008. Signatories complete a self assessment each year. This year, after consultation with signatories, changes were made to the reporting framework. Signatories were asked to complete a pilot assessment on a voluntary (non-public) basis, prior to reporting becoming mandatory again in 2013. Lothian Pension Fund participated in the pilot and submitted feedback to UN PRI on the new framework. UN PRI aim to deliver a report to signatories on their assessments by end 2012.

Recommendations

It is recommended that the Pensions Committee:-

1. note the contents of this report.
2. endorse Councillor Cameron Rose's nomination to stand for re-election to the LAPFF Executive and for the position of Chair.

Measures of success

Success of engagement with companies is very difficult to measure. Hermes measure their success by setting and measuring 'milestones' in engagements.

Financial impact

There are no direct financial implications of this report. Arguably, ESG issues affect the financial performance of companies and the performance of the Funds.

Equalities impact

There are no adverse equalities impacts arising from this report.

Sustainability impact

ESG activity is expected to contribute to the sustainability of the Funds' investments.

Consultation and engagement

The Funds' policy on ESG issues is included in Statement of Investment Principles which was agreed after consultation with stakeholders. Stakeholders are kept informed of ESG activity via the Funds' website.

Background reading / external references

Not applicable.

Links

Coalition pledges	
Council outcomes	CO26 – The Council engages with stakeholders and works in partnerships to improve services and deliver agreed objectives.
Single Outcome Agreement	
Appendices	Appendix 1 - Hermes Q3 Public Engagement report Appendix 2 - LPF engagement with top 10 holdings Appendix 3 - LAPFF Quarterly Engagement report July to September 2012

Hermes Equity Ownership Services

Public engagement report

Q3 2012

HERMES

Q3

This report contains a summary of the responsible ownership activities undertaken by EOS on behalf of its clients. It covers significant themes that have informed some of our intensive engagements with companies in Q3 2012. The report also provides information on our voting decisions and the steps we have taken to promote global best practice, improvements in public policy and collaborative work with other shareholders.

Contents

What is EOS?

Hermes Equity Ownership Services (EOS) helps institutional shareowners around the world to meet their fiduciary responsibilities and become active owners of public companies. EOS' team of engagement and voting specialists monitors its clients' investments in companies and intervenes where necessary with the aim of improving performance. EOS' activities are based on the premise that companies with informed and involved shareholders are more likely to achieve superior long-term performance than those without.
Through pooling resource with other like-minded funds to create a stronger and more representative shareholder voice, our joint company engagements can be more effective. We currently act on behalf of 24 investors with roughly 143 bn. USD* in Assets under stewardship.

Hermes has the largest stewardship resource of any fund manager in the world. Our 28 person team includes former CEOs and other board members of public companies, as well as senior strategists, corporate governance experts, investment bankers, fund managers, lawyers and accountants.

The depth and breadth of this resource reflects our philosophy that ownership activities require an integrated and skilled approach. Intervention at senior management and board director level should be carried out by individuals with the right skills and with credibility. Making realistic and realisable demands of companies, informed by significant hands-on experience of business management and strategy setting is critical to the success of our engagements.

Hermes has extensive experience of implementing the United Nations' Principles for Responsible Investment (UN PRI). EOS' Chief Executive Colin Melvin chaired the committee that drew up the original principles and we are actively engaged in a variety of work-streams, through the clearinghouse and in the revision of the PRI reporting framework. This insight enables EOS to help signatories to meet the challenges of effective PRI implementation.

*as at 31st of December 2011

How does EOS work?

EOS uses a proprietary screening process to determine which companies will benefit from intensive engagement. The first element of this screen looks at the companies' ability to create shareholder value by comparing the weighted average cost of capital with cash returns to investors. We then apply further screens across a range of other metrics including environmental and social issues. Finally, we assesses the prospects for engagement success.

The Hermes Responsible Ownership Principles set out our basic expectations of companies in which our clients invest. These cover business strategy, communications, financial structure, governance and management of social, ethical and environmental risks. The Principles and their regional iterations guide our intervention with companies throughout the world. Our approach is pragmatic and company and market specific, taking into account individual company circumstances.

We escalate the intensity of our involvement with companies over time depending on the nature of the challenges they face and the attitude of the board towards our intervention. Some engagements involve one or two meetings over a period of months, others are more complex and entail multiple meetings with different board members over several years.

At any one time there are many companies included within our engagement programmes, meaning that significant additional resources are dedicated to these situations. All of our engagements are undertaken subject to a rigorous initial assessment and ongoing review process to ensure that we are focusing our efforts where they can add most value for our clients.

While we are robust in our dealings with companies, the aim is to deliver value to clients, not to seek headlines through campaigns. These can often undermine the trust which would otherwise exist between a company and its owners. We aim to be honest and open with companies about the nature of our discussions and will seek to keep such discussions private. Not only has this proved the most effective way to bring about change, it also acts as a protection to our clients, so that their position will not be misrepresented in the press.

For these reasons, this public report does not contain specific details of our interactions with companies but aims to bring clarity on some of the most important issues relevant to responsible owners today and EOS' related activities in these areas.

We would be delighted to discuss EOS with you in greater detail.

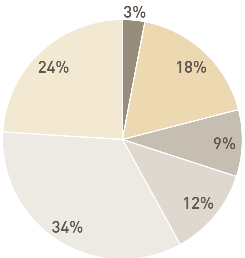
For further information please contact Colin Melvin on +44(0)207 680 2251.

Engagement by region

Over the last quarter we engaged with 151 companies on a range of 327 social, environmental and governance issues. EOS' holistic approach to engagement means that we will typically engage with companies on more than one issue simultaneously. The engagements included in these figures are in addition to our discussions with companies around voting matters.

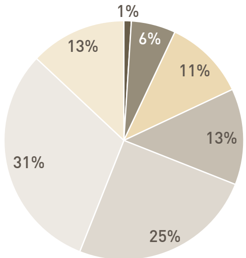
North America

We engaged with 17 companies on a range of 33 issues over the last quarter.



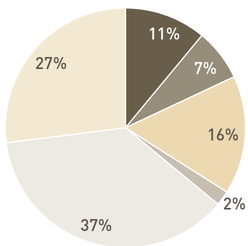
Asia

We engaged with 33 companies on a range of 80 issues over the last quarter.



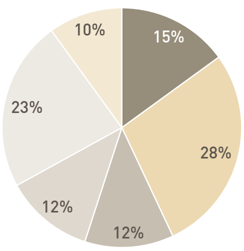
Australia & New Zealand

We engaged with 17 companies on a range of 45 issues over the last quarter.



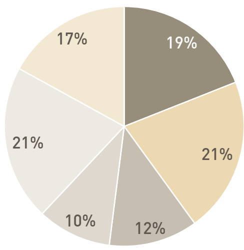
Emerging & Frontier Markets

We engaged with 26 companies on a range of 52 issues over the last quarter.



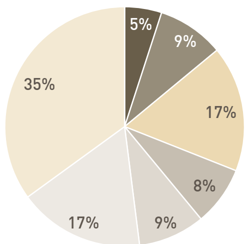
Europe

We engaged with 25 companies on a range of 42 issues over the last quarter.



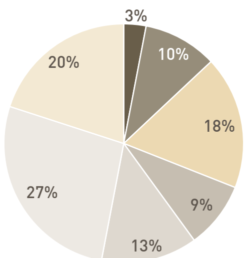
UK

We engaged with 33 companies on a range of 75 issues over the last quarter.



Global

We engaged with 151 companies on a range of 327 issues over the last quarter.



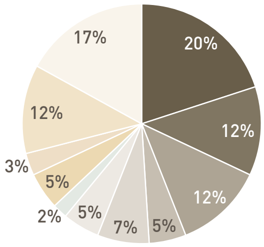
- Shareholder communications
- Environmental
- Social and ethical
- Risk management
- Business strategy
- Governance
- Remuneration

Engagement by issue

A summary of the 327 issues on which we engaged with companies over the last quarter is shown below.

Social and ethical

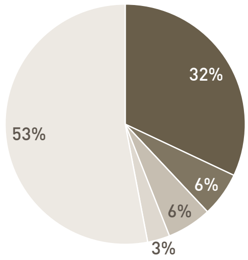
Social and ethical issues featured in 18% of our global engagements over the last quarter.



- Employee relations
- Community relations
- Health and safety
- Supply chain (inc child/other labour issues)
- Operations in troubled regions
- Corporate culture
- Munitions manufacture
- Access to medicines/clinical trials
- Political risk management
- Bribery and corruption
- Other social & ethical

Environmental

Environmental issues featured in 10% of our global engagements over the last quarter.



- Climate change/carbon intensity
- Water stress
- Forestry
- Biodiversity
- Other environmental

Other engagement

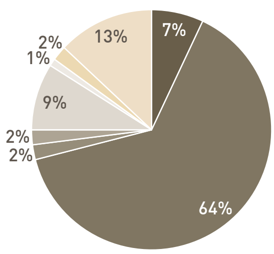
Remuneration featured in 20% of our engagements over the last quarter.

Risk management featured in 9% of our engagements over the last quarter.

Shareholder communications featured in 3% of our engagements over the last quarter.

Governance

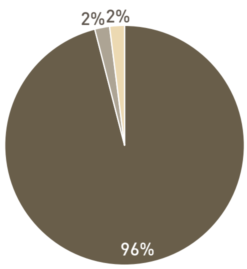
Governance issues featured in 27% of our global engagements over the last quarter.



- Accounting or auditing issues
- Board structure
- Committee structure
- Related party transactions
- Succession planning
- Poison pill
- Separation chair/CEO
- Other governance

Business strategy

Business strategy issues featured in 13% of our global engagements over the last quarter.



- Business strategy
- Returns to shareholders
- Capital structure

Business strategy and board structure

Strategic engagements

Many of EOS' most successful engagements combine discussions of business strategy and structural governance issues.

Statistics	
Number of companies engaged with on strategic matters this quarter:	40
North America	4
Asia	19
Australia and New Zealand	0
Emerging and Frontier Markets	6
Europe	4
UK	7

Number of significant steps forward in strategic/governance engagements this quarter:	37
North America	10
Asia	4
Australia and New Zealand	0
Emerging and Frontier Markets	13
Europe	5
UK	5

Overview

EOS' holistic approach to engagement combines discussions on business strategy and risk management, including social and ethical risks, with structural governance issues. Our engagements fill the gap left by the investment industry's tendency to focus on the short-term. The result of this tendency is that management too often goes unchallenged in its approach to the long-term future of its business and there is minimal pressure for change. EOS assesses and engages with underperforming companies from a long-term perspective, asking questions which encourage management and boards to think afresh to overturn long-running periods of underperformance. This proven approach is often successful in adding value or ending destruction of value.

Business strategy is also a key feature of other engagements such as those highlighted elsewhere in this report. We are generally most successful in achieving change on environmental, social and other matters where we lead the conversation from a business perspective and focus on these issues as risks to the company's strategic positioning. Companies can become locked into historic patterns where they are overdue for refreshment and new perspectives on the board. Injecting new thinking at the head of the company – an independent chair or change of CEO – is frequently the key to unlocking change and driving renewed operational performance, creating long-term value for shareholders.

Engagements on governance and business strategy may require a series of meetings over months and years. It takes time for board changes to generate the business and strategic changes which improve long-term performance.

Examples of successful engagements

We spoke with executives from a **North American conglomerate** to test the effectiveness of its governance structures. We tested the company on two new recent additions to its board in order to gain a better understanding of the skill-set and anticipated contribution they will bring. We have previously encouraged the company to consider enhancing both the financial and international expertise on its board and are pleased that the two newly appointed directors bring extensive such experience. Despite this positive step, we questioned the size of the board, which has swelled to 18 directors, and discussed a process for shrinking it over time. We pressed for details about the newly formed board risk committee which has been tasked with enhancing oversight of a particular area of the business and welcomed the board's stronger approach to this business. We challenged the company to demonstrate how its board operates in practice in order to examine the effectiveness of the current leadership structure in providing appropriate


independent oversight and accountability. We had previously expressed our desire to see the roles of CEO and chair separated, although we agreed that the shift could occur gradually provided a sufficiently robust independent lead director and board is in place in the interim. Despite some positive insights into the current workings and dynamics of the board, we continued to advocate that the board remain open to splitting the roles upon the succession of the current CEO.

We met with the chair of the remuneration committee of a **Japanese electronics company** at the firm's Tokyo headquarters in order to progress our discussion on corporate governance and strategy. It is exceptional for a shareholder to be able to access an independent director in Japan so this marks a major step forward in our engagement. We queried the company's rationale for retaining its former CEO as chair and expressed concerns that this might limit the scope of the new CEO to implement critical reforms to the business. We gained insight into the former CEO's ongoing importance to the entertainment business, but won assurances that he no longer has any executive functions so that the new CEO is not hampered. We gained further reassurances that the speed of decision-making has improved since the change of management and that there are signs of positive momentum in the business. While we were pleased to have gained further assurances on remuneration structures, we pressed the remuneration committee chair to enhance the level and quality of disclosure so as to be more accountable to shareholders.

We met with the chair of the minority shareholder committee at a **bank in the Emerging Markets** and were invited to become a member of the committee, in order to represent international investors and to make recommendations to the board. The committee meets on a monthly basis and is currently composed of six members. The committee's most important project over the coming months will be to present a list of independent candidates for election to the board at the May AGM. As well as proposing potential candidates, EOS was also asked to lead international minority shareholders in this endeavour and help garner support for the election of independent candidates among other institutional investors. Directors in the country are elected by cumulative voting and in order to ensure the election of an independent director, around 6% of the votes are needed.

We met with the chair of the governance and nomination committee of a **European financial institution**. We discussed the composition and functioning of the board and challenged what in our view is the chair's excessive satisfaction with current structures and processes given the performance of the bank and specific dysfunctions, such as that in the management of human resources. We gained reassurance on the quality of the board but pressed for more formal nomination and evaluation processes. We also questioned the need for the presence of a non-voting director who is systematically absent from board meetings and nominated for historical reasons that could not be specified. Despite previous commitments to us from the chair, vice-chair and secretary of the board that the governance structure would be thoroughly reviewed by 2015, the chair of the governance committee strongly argued in favour of continuing to combine the roles of chair and CEO. He first dismissed a recent related shareholders' resolution which gained 25% support, but then acknowledged our strong concerns. We agreed to continue our dialogue to arrive at an unbiased assessment of the governance structure.

We met with the new chair of a **UK insurance company** to discuss a number of his priorities on the board, in particular the qualities he will be looking for in forthcoming non-executive appointments. We queried the challenges in finding the right candidates given the clear difficulties the company faced when looking for its chair and received some assurances that due to these roles being both less demanding on time and requiring a different skill-set the pool of candidates remains high calibre. He agreed with us that, due to a number of recent incidents at the company including the failure of a deal, the board needs to make substantial efforts to improve communications with shareholders and thus trust. This will include more regular interactions with him and the board's committee chairs in the future and we pressed that his communication with investors will be key to how the company's shareholders will judge his performance as chair.

Investing responsibly in sovereign bonds

Dealing with the challenges of responsible investment in a major asset class

Best practices in responsible investment in the sovereign fixed income asset class are still developing. This article sets out our current understanding of best in class approaches in the area.

'The nature of the issuers essentially means that the difference between engagement and policy work disappears. There is thus a much reduced set of tools available for responsible investors to use, and most of the focus is placed on exclusions and integration.'

Overview

"Blood bonds: Investments in corruption and oppression" is an arresting but unattractive title for a paper, a particularly unattractive one when that paper alleges that a number of funds have made investments of precisely that nature. The paper was published in May by DanWatch, a Non-Governmental Organisation (NGO) which seeks to promote its view of more responsible investment by Danish funds, and local newspaper Berlingske. But the questions which the paper raises are, deliberately, universal. Only some institutional investors with an interest in responsible investment are yet beginning to have answers to those questions.

As ever, institutional investors will not wish to be prey to every issue raised by every NGO. However, when criticisms strike home with beneficiaries and clients, or when (as it has occurred in Denmark) the government has encouraged greater attention to the issues raised, then inevitably funds will need to work to develop approaches to those issues.

This article attempts to set out a possible approach to responsible investment in government bonds. Inevitably, in an asset class where best practice is still developing and in many ways is still in its infancy, this cannot represent a finalised approach, and certainly does not purport to be definitive. However, this is what 'in our experience' currently amounts to best practice. It benefits from, among other things, our active and ongoing participation in the United Nations (UN) backed Principles for Responsible Investment (PRI) sovereign fixed income working group, whose face to face meeting we were pleased to host in July 2012.

Readers will be familiar with the standard toolkit available to the responsible investor: exclusions, investment integration, voting, engagement and policy work. One of these - voting - is irrelevant in the context of sovereign bonds, and given the nature of the issuers of bonds many assume that engagement is impossible. This is not necessarily the case, as we discuss below, but the nature of the issuers does essentially mean that the difference between engagement and policy work disappears. There is thus a much reduced set of tools available for investors to use, and most of the focus is therefore placed on exclusions and integration, with the former the furthest advanced.

There are a number of reports and considerations which might form a basis for exclusions. The DanWatch report identified eight problematic African countries using only two criteria, which some have suggested were somewhat arbitrary: the Transparency International corruption perception index, and the Freedom House freedom index, targeting, so DanWatch puts it, investments in regimes which are potentially corrupt and abusive of human rights. It is not apparent why the study focused solely on Africa nor on these eight countries, ignoring lower-rated states.

Interestingly, we had in place a simple screening tool for a client, identifying those countries subject to UN and/or European Union sanctions where the sanctions regimes were not merely historic artefacts and where we believed that the client should formally consider whether it wanted exposure to those regimes. We applied intelligence and judgement to this list, including regimes with questionable human rights and corruption records even where the sanctions were largely in relation to historic leadership. This screening tool captured some of the eight countries which DanWatch identified as problematic, as well as the four countries which their report notes have lower scores than any of the eight it does focus on.

We recognise that, though it applies appropriate judgement, this approach is not yet as broad and robust as it might be. The developing best in class approach would be to combine this intelligent understanding of sanctions with a broader set of assessments based on broader norms. Different clients will have different concerns acting as drivers within such a framework, with some emphasising indiscriminate weapons, some with greater concerns about human rights or corruption, and some with more bespoke concerns such as press freedom. In some cases the framing provided by the banner issues of the UN Global Compact may assist by linking their approach to sovereign bonds with that for corporate risks. We are seeking to assist in the development of such tools.

Integration essentially relies on developing considerations of which Environmental, Social and Governance (ESG) factors will have an impact on sovereign bond returns over the long run, understanding these factors at the level of the nation-state. This is an area where considerable work is going on, and so far has been the major focus for the PRI's working group – which has worked to develop case studies and statistical analyses that identify where key ESG risks have had important influences on the sustainability of regimes and of their ability to continue to fund their financial commitments.

Amongst the factors that we believe may be relevant to integrate are the following, in no particular order. Under the Environmental banner: climate change sensitivity and adaptability; water intensity and potential shortages; carbon intensity of the economy; general environmental pollution; and land use intensity and flexibility. Regarding Social issues: human rights protections and abuse; labour rights and protections; business integrity and corruption. And with respect to Governance issues: rule of law; ease of doing business; consistency and reliability of regulation; and property rights protections. All of these (and other) factors seem likely to us to impact a country's long-term capacity to finance its liabilities.

There are a number of research houses which provide ESG ratings for countries using these sorts of metrics. The challenge for asset owners then is to encourage their fund managers to consider and where relevant integrate these factors into their decision-making, whether on an 'all-other-things-being-equal' basis or by requiring a more active integration. Developing benchmarks which reflect some of these issues would assist in encouraging this integration or at least allow a richer assessment of fund manager performance.

A further way to bolster integration strays into the area of engagement, for one main route to ensure that longer-term factors are included in sovereign bond assessments would be for the ratings agencies to build them into their models. We have had some conversations with ratings agencies along these lines and a forthcoming task of the PRI working group is to take this forwards collectively. There is also, in spite of the obvious challenges, some scope for engagement with the issuers of sovereign bonds. For example, many responsible investors already look to engage with governments on their climate change policies. Typically this is done from their perspective as investors in companies and assets in that country, but it is only a small extension to make the link to the overall sustainability of government finances and concerns as investors in sovereign bonds. Leading countries already have processes to tap the views of the key buyers of their bonds, and so are seeking to be open to appropriate influence. Of all the emerging areas in the field of responsible investment in sovereign bonds, this in particular is an area of developing practice, but there is much less difficulty in carrying this work forwards than many tend to assume.

Conflict Minerals

Smart phones and crimes against humanity: Addressing the use of conflict minerals in the electronics industry.

For more than a century, the Democratic Republic of the Congo has been plagued by regional conflict and a deadly scramble for its vast natural resources. The majority of these minerals eventually wind up in electronic devices such as cell phones, portable music players, and computers.

'Clearly any link in a company's supply chain which has the potential to facilitate the breach of fundamental human rights is not only unacceptable as a matter of policy and principle but also is damaging to a company's reputation and the value of our clients' investment.'

Overview

Over the past several years Hermes Equity Ownership Services (EOS) has undertaken a programme of engagement with electronics companies on the issue of minerals sourcing from the eastern regions of the Democratic Republic of Congo (DRC).

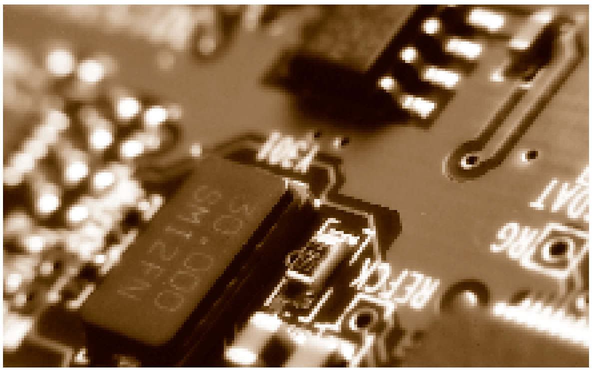
This engagement was prompted by concerns over the continuing link between multinational corporations which source minerals mined in the war-torn DRC and armed rebel groups responsible for human rights violations.

So called 'conflict minerals' can turn up in a wide array of electronic products such as smart phones, MP3 players, and laptop computers amongst others. Consumers in the United States, Europe and Asia are the ultimate end-users of these conflict minerals and are inadvertently fuelling the war in the DRC through the purchase of these electronics products. We believe that the use of conflict minerals in these products can result in significant reputational risks. EOS has engaged with global consumer electronics companies to ensure that their policies on supply chains are transparent and sufficiently robust to address these risks.

Since 2009 EOS has led a collaborative engagement effort along with members of the United Nations (UN) backed Principles for Responsible Investment (PRI) targeting major electronics companies in North America, Europe, and Japan on the issue of minerals sourcing from the DRC.

The three main minerals in question are tin, tantalum, and tungsten, which are used in nearly all types of electronics products including mobile phones, MP3 players and laptop computers.

The DRC has been the scene of some of the deadliest conflict since World War II. It remains amongst the most dangerous places in the world to live, in significant part because of the international demand for minerals found in the eastern Congo. Whilst eastern Congo is a complex crisis — fuelled by tensions over land, rights, identity, regional power struggles and the fundamental weaknesses of Congo as a state — the trade in conflict minerals remains one of the key drivers of the conflict. The same armed groups that reap enormous profits from the mineral trade in eastern Congo regularly commit human rights abuses as they jockey to control the region's most valuable mines, transportation routes, and opportunities to impose



extortionary 'taxes' on those involved in this trade. This violence is also hampering the establishment of civil society in the region and ensures local people remain in poverty. While it is difficult to determine the full extent to which militia groups profit from these minerals it has been estimated that in 2008 alone armed groups in the Congo earned approximately US$185 million from the trade.

The link between armed groups and the mineral trade has been well documented by numerous international organisations, including the UN. The UN panel recommended due diligence in the international minerals supply chain as an effective strategy to cut off support to the Congolese rebels derived from these mining activities.

Since the launch of this initiative, EOS has encouraged electronics companies to play a significant role in combating the trade in conflict minerals in eastern Congo. Initiatives include publicly disclosing their supply chains for components containing tin, tantalum and tungsten and by working with relevant organisation and industry peers. This collaboration would encourage the development of robust and internationally accepted mechanisms to verify the origin of these minerals and promote responsible and sustainable mining practices.

Our efforts received a significant positive boost in August 2012. The United States Securities and Exchange Commission (SEC) adopted a final rule implementing disclosure and reporting requirements regarding the use of conflict minerals from the DRC. This rule is part of reforms introduced under the Dodd-Frank Wall Street Reform and Consumer Protection Act. The legislation requires disclosure by companies that use gold, tin, tantalum and tungsten in their products to determine whether such metals originate from particular mines in the DRC or adjoining countries.

Throughout the rule-making process we have worked with the SEC as part of a multi-stakeholder network. This network comprised of a diverse mix of organisations, including issuers from several industrial sectors, socially responsible, and faith-based investors, and non-governmental organisations.

The issuance of this new rule is a significant milestone in our collective efforts to eliminate the link between violence and human rights abuses and the mineral trade in the DRC and surrounding countries. This rule will also allow investors to evaluate the efforts of companies in other industries ranging from auto parts to retailers and jewellers, to identify and eliminate the use of conflict minerals in their supply chains as well.

Clearly any link in a company's supply chain which has the potential to facilitate the breach of fundamental human rights is not only unacceptable as a matter of policy and principle but is also damaging to a company's reputation and the value of our clients' investment. We commend the significant positive steps taken by industry, governments and investors alike to address this serious issue and will continue to support collaborative efforts aimed at furthering the elimination of conflict minerals from global supply chains.

Health and Safety in the mining industry

Enhancing measures and transparency

Hermes Equity Ownership Services (EOS) engages with mining companies across the world to ensure the efficient management of health and safety and other sustainability risks. It seeks to encourage a corporate culture where employees' safety is protected, to minimize overall health and safety risks, and to enhance shareholder value.

Statistics	
Number of companies engaged with:	22
Number of companies where substantive change sought:	22
Number of these showing progress so far:	5

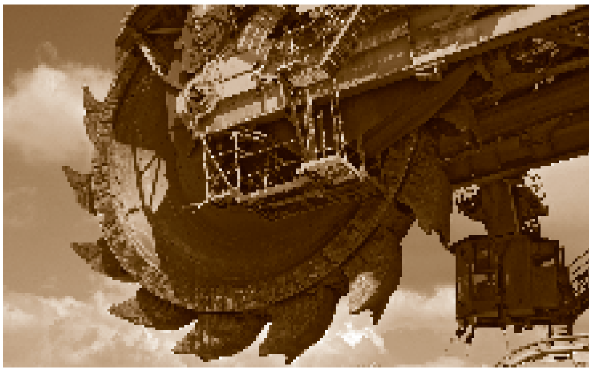
Overview

Health and safety risks are a a global challenge for mining companies. Despite the implementation of comprehensive health and safety management systems by companies across the mining and metals industry, actual and potentially fatal events continue to occur with unacceptable frequency. As a result, EOS engages with mining companies globally to encourage the improvement of safety performance and to minimize health risks throughout operations.

EOS understands that, given various level of enforcement and the consequences of the regulations and laws, the severity of the health and safety problems vary by region. Mines in certain regions receive greater attention on health and safety risk management from their investors and from regulators than others. For example, the Chinese coal mining industry's record on accidents and deaths is well documented, reported and discussed. Tragic accidents constantly appear in the headlines of global and local press. Two explosions at the Raspadskaya coal mine, which killed 67 miners, injured 134 and left 23 missing, meanwhile indicate that the health and safety risks in Russia are potentially also severe.

EOS's engagement with mining companies aims to help reduce such events and to encourage the continuous improvement of existing safety and risk management systems. Through efficient management systems, EOS encourages companies to foster a safe and healthy working environment as well as to reduce fatalities, injury rates, occupational illnesses and the number of accidents.

EOS has categorised engagement on health and safety risks with mining companies into the following three issues: fatalities, injuries and occupational illness; board oversight and corporate governance culture; and health and environmental impacts on the local community. We engage with mining companies across the world, including in Australia, Canada, China, Germany, India, Indonesia, Poland, Russia, South Africa and the United States of America.



The objective of our engagement is to encourage mining companies to do 'Zero Harm' to their personnel or the environment and to give appropriate consideration to health and safety in the design, operation and maintenance of project facilities. Mining companies should provide a safe workplace and should strive for the elimination of incidents. We believe the greatest gains can be made by preventing accidents and occupational illnesses through encouraging workers and supervisors to work together in an atmosphere where safety is the highest priority.

In our focus on fatalities, injuries and occupational illness, EOS believes that companies demonstrating an outstanding safety record should have good risk management procedures, well trained crews and robust safety empowerment. These are integrated into both the workers' and the supervisors' internal responsibility systems. We believe that the first defensive measure against fatal accidents is to prevent them. This means ensuring that a company's personnel receive sufficient training and comply with controls identified to manage potential fatal risk. Competency assessment and continuous education of personnel are crucial to consistently enforce the understanding of these controls for the prevention of fatal incidents as well as enforcing the responsibility within the programme. Individuals at all levels should be held accountable for the implementation of fatal risk controls.

Companies should also adopt an effective methodology to prevent fatal and accidental risks. We encourage companies to involve operational expertise from different levels within the organisation in the analyses of fatal and accidental risk. The preventative actions should be able to identify potential fatal incidents. Assessments should be made to track the completion of the actions, to review their effectiveness, to evaluate critical controls for fatal and accidental risks and to set appropriate performance standards. Planning and budgeting processes should also be considered when implementing engineering controls.

Whilst accidents occur, it is important to conduct investigations to understand and analyse the root cause of fatal incidents, and the potential root cause for potential high risk incidents. The findings of such investigations should be promptly and appropriately fed back into the fatality prevention program. Importantly, companies should facilitate an open reporting culture on their operations and accidents. Some mining companies in the Asian emerging markets tend to have relatively poor disclosure. We believe that committing to the open and transparent sharing of information and collective actions on health and safety issues could assist those companies striving to do 'Zero Harm'.

EOS does not only encourage companies to have effective health and safety programmes in place, we also encourage company boards to be aware of the actual and the potential risks. Board leadership in health and safety issues does matter to a company's safety performance. We believe that a board's active and direct participation, underpinned by rigorous oversight of health and safety risk management, is vital in achieving a company's goal of a 'Zero Harm' working environment. Safety leadership must be evidenced and instilled at all levels, from the chief executive officer to the broader workforce, in order to change human behaviour. A board's commitment to safety performance will motivate and empower workers to drive a sustained safety culture within the company.

Lastly, environmental and health impacts are intertwined with a local community. We believe companies should carry out health and environmental impact assessments on local and nearby communities when designing mining projects. Mining companies should undertake appropriate measures to mitigate potential negative impacts on local and nearby communities and to protect the environment, local bio-diversity and broader public health. In the event that damage is caused, it could lead to financial consequences for companies, which could include huge compensation liabilities and could potentially halt the operations. For example, EOS had an intensive engagement with a major Chinese gold mining company that had an incident where waste water leaked into the local ecosystem. The toxic elements caused damage to the local ecosystem, which in turn caused damage to fishery businesses and to public health, due to the presence of toxic elements in drinking water.

EOS continues to engage with mining and metals companies to highlight major risks and to encourage them to pursue appropriate health and safety programs. The programs should be implemented effectively through bottom-up behavioural change as well as top-down management. We also continue to observe regulatory development in different markets and, where necessary, proactively engage with relevant regulators on the enhancement of health and safety risk management measures for mining operations.

Ethics in pharmaceutical companies

Mitigating the exploitation of vulnerable groups during drug development and approval processes.

Hermes Equity Ownership Services (EOS) engages with pharmaceutical companies to encourage a greater focus on ethical standards during the pre-research and development stages and during the subsequent clinical trials stage of drug development. In order to protect the rights and welfare of clinical trial participants, we seek to engage with the boards of pharmaceutical companies to ensure that sustainability risks are appropriately overseen.

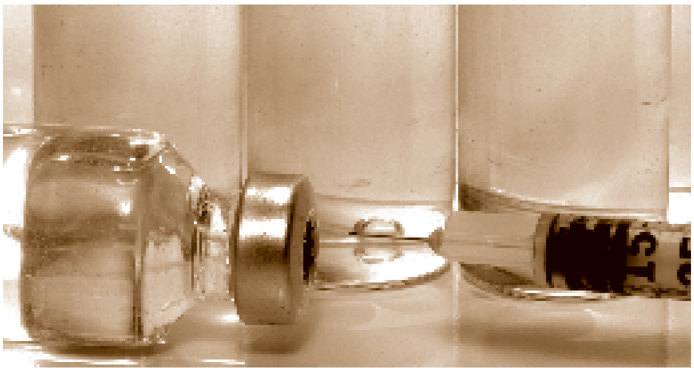
'To ensure that population groups and communities continue to benefit from new drugs and that business needs are appropriately managed, pharmaceutical companies should ensure appropriate board level oversight of pre-research and development processes as well as clinical trials.'

Overview

There is a trend among multi-national pharmaceutical companies to undertake clinical research in developing markets. Given the poor levels of healthcare available in these regions EOS is concerned about the potential exploitation of vulnerable groups, including the financially vulnerable and the illiterate. Such groups may be participating in clinical trials as their only means of receiving health care. We have conducted engagements on this theme which included a site visit to a government hospital in India. During this visit we met with clinical trial physicians to gain an understanding of how pharmaceutical company policies on pre-research and development and clinical trials are implemented in practice. EOS has engaged with pharmaceutical companies throughout the research and development process, since we are concerned that the incentives for clinical trial physicians could be misaligned. Added to these concerns is the issue of ensuring the integrity of data in the recording of clinical trial results to regulators and the disclosure of negative findings.

Through engagement, EOS aims to ensure that companies in the pharmaceutical industry have the necessary monitoring responsibilities in place and that they adhere to international standards to facilitate a reduction of inappropriate practices. EOS impresses on pharmaceutical companies the importance of providing additional safeguards when conducting clinical trials amongst vulnerable groups. Such safeguards are essential to avoid the dangers of exploitation and of compromised consent, both of which have been areas of controversy in developing markets.

Whilst some pharmaceutical companies have assured us that they adhere to all applicable international standards as well as the guidelines of the local drug approval authority, we are not convinced that these companies are aware of the specific risks and oversight measures that need to be in place. On the other hand some companies have well developed processes in place which attempt to safeguard against key risks in the pre-research and development stages. To underline our engagement on these issues, we have focused on the recruitment stage of clinical trials, encouraging pharmaceutical companies to provide assurance of the correct board level oversight.



A lack of affordable health care in many countries around the world means that patients may be expected to pay for drugs, tests and medical procedures that they cannot afford. The impact of such medical expenses can force patients to sell assets, go into debt or even stop essential treatment.

Clinical data submitted to the European drug regulators to secure market approval for new drugs includes data obtained from trials in low and middle income countries. Some operators of clinical trials in developing countries have faced the criticism that they have exploited individuals who do not have access to good quality and affordable care, and who may therefore may accept offers of clinical trials that potentially provide better quality and free treatment. In some developing countries there may be a weaker regulatory system that protects clinical trial participants. In addition patient consent could be compromised by factors such as their medical condition, education levels and poverty. These factors could influence patients' ability to understand the risks involved in the clinical trial and could also influence their desire to participate. In developing countries patients may not question their doctor's judgement and may be easily influenced by their advice. They may also think that refusal to follow the doctor's advice to participate in a trial would affect their access to healthcare. We encourage companies to train doctors to avoid undue influence and the potential misunderstanding that clinical trials are an individual's only treatment option. Instead, the risks involved in being recruited for various phases of clinical trials should be explained to patients. Doctors should be clear about the varying risks, limitations and strengths of different treatment options.

During our engagements, EOS therefore stresses the importance of ensuring appropriate training is provided to the physicians running the clinical trials so that factors influencing a patient's judgement can be taken into account. Another important risk is the acknowledgement that conflict of interests may arise through doctors being given substantial incentives to recruit their own patients into clinical trials, such as fees and all-expenses paid conferences abroad. This is particularly acute when the clinical trial physician is also the patient's primary doctor. Our engagements on this issue have encouraged pharmaceutical companies to identify, manage and mitigate such conflicts of interest, especially when developing incentives to recruit clinical trial participants.

Since the application of ethical codes can vary across geographies, we encourage companies to ensure that clinical trials are conducted according to the principles of the declaration of Helsinki, local good clinical practice guidelines and the assurance that patients are giving prior and informed consent before enrolment into a clinical trial. In line with this guidance, we expect companies to justify that research is responsive to the health needs and priorities of the specific population group or community and that there is a reasonable likelihood that the specific population group or community could benefit from the outcome of the research. Within the clinical trial recruitment process we seek to ensure that no payments are made to participants which could potentially influence their judgement on whether to participate in a clinical trial. Furthermore, we seek to ensure that the incentives for recruiters of clinical trial participants drive the right type of behaviours and do not focus only on the number of participants recruited. In the event that the pharmaceutical company operates its trials through a subsidiary, we encourage the group wide values, ethics and compliance processes to be integrated into the subsidiary and for the group's strategic priorities to be implemented.

During our engagement with pharmaceutical companies on the research and development processes as well as the testing of new drugs, we also consider the existence of whistle blowing policies. Such policies guide the procedure around highlighting issues that undermine the integrity of the data to the appropriate management level. We have assisted one particular company in its investigation of our findings around clinical trials, it has been open about the biggest challenges it faces during the research phase and implementation. This is an issue faced by many companies in the industry and EOS has been impressed at the speed with which certain pharmaceutical companies have responded to our concerns. We believe this is a reflection of improvements within the corporate culture at those companies.

Clinical trials have helped to develop and improve drugs from which many people have benefitted. To ensure that population groups and communities continue to benefit from new drugs and that business needs are appropriately managed, pharmaceutical companies should ensure appropriate board level oversight of pre-research and development processes as well as clinical trials.

Companies affected by these issues include: AstraZeneca, Bayer, GlaxoSmithKline, Johnson & Johnson, Merck, Novartis, Pfizer, Roche, Sanofi, Takeda Pharmaceutical

Public policy and best practice

Protecting and enhancing value by promoting better regulations

Hermes Equity Ownership Services (EOS) contributes to the development of policy and best practice on corporate governance, corporate responsibility and shareholder rights to protect and enhance the value of its clients' shareholdings over the longer term.

Overview

EOS actively participates in debates on public policy matters to protect and enhance value for clients by increasing shareholder rights and boosting protection for minority shareholders. This work extends across: company law, which in many markets sets a basic foundation for shareholder rights; securities laws, which frame the operation of the markets and ensure that value creation is reflected in value for shareholders; and in developing codes of best practice for governance, management of key risks and disclosure. In addition to this work on a country-specific basis, we address regulations with a global remit, which are currently in the areas of accounting and auditing standards.

Investment institutions are typically absent from public policy debates even though they can have a profound impact on shareholder value. EOS seeks to fill this gap.

By playing a full role in shaping these standards we can ensure that they work in the interests of shareholders rather than being moulded to the narrow interests of other market participants (particularly companies, lawyers and accounting firms, which tend to be more active than investors in these debates) whose interests may be markedly different.

Highlighted sample activities

Enhanced Disclosure Task Force meetings

We participated in a number of meetings of the Enhanced Disclosure Task Force, established by the Financial Stability Board to promote better risk reporting by banks. We have the privilege of being one of only a handful of investors to be a member. While we believe that the bulk of what will be delivered will be a significant advance, we have worked to ensure that the co-chairs of the Task Force feel direct pressure (from all the investor participants as well as ourselves) about the need to deliver genuinely stretching standards which will reawaken trust in banks' accounting. We are also working with the other investors in the group and with other major institutions around the world to encourage direct engagement with the banks on the Task Force, such that they feel more fully the need to deliver something substantial through this process.

Investor Statement on Foreign Corrupt Practices Act

We co-signed an investor statement in support of the Foreign Corrupt Practices Act. This statement has been put out in reaction to the US Chamber of Commerce's call for changes or 'clarifications' to the Act, which we believe would weaken its effectiveness in fighting bribery and corruption globally. This investor action followed a meeting which one of the authors of the letter had with the Securities and Exchange Commission and the Department of Justice.

Meeting with Tokyo Stock Exchange senior executives

We met with the Tokyo Stock Exchange to discuss recent changes in corporate governance rules and how we can continue working together to promote best practice further. We welcomed a number of recent amendments to the Company Act, in line with our persistent efforts and requests to date, such as strengthening the definitions of outside directors to enhance independent board representation, requiring a 'comply or explain' approach to board structure, and improved regulations on issuing new shares via third-party placement. We discussed additional guidance which we believe is critical for effective implementation of governance reform. In particular, we noted the need for clear guidance on the different roles and duties of independent board directors compared with those of outside statutory auditors when the new optional board structure includes an 'audit and supervisory committee', so that this new structure can be effective. We reiterated our strong belief in the need to develop a Corporate Governance Code with a practical framework and a 'comply or explain' approach to ensure that there is an open and constructive dialogue between companies and their shareholders. We also suggested that the TSE, with an active participation and support of investors, consider corporate governance awards for Japanese companies to encourage best practice to develop. We offered to work together to advance this.

Presentation on necessary governance reforms in Taiwan

We gave a keynote speech on executive remuneration and wider corporate governance issues at the Taiwan Corporate Governance Association. We explained why executive remuneration matters, outlined the issues and problems associated with current practices and provided an overview of recent events and developments in Europe and the US. We also used the opportunity to present some of our ideas for reform of pay structures and our activities to promote these amongst companies, investors and regulators. Whilst the topic is not yet on top of the corporate governance agenda in Taiwan, there were many questions and a lively debate following our presentation. It became apparent that the role and influence of directors representing the state is a corporate governance issue of particular concern in Taiwan. As a first step to address apparent problems, the Association is keen to provide formal training to such directors, so that they better understand their proper role and legal obligations. We shared our experience with state shareholders in other markets and offered our help with regard to the director training programme. We used the presentation and the subsequent debate to make a number of proposals regarding corporate governance in Taiwan, focusing in particular on board nominations and composition as well as transparency and the role of shareholders with regard to major corporate transactions.

Consultation on executive remuneration in France

We responded to a government consultation on remuneration which will inform legislative changes. We strongly promoted the concept of a vote on a special report on remuneration and set out precisely the information this report should provide. In our view, such a vote would significantly enhance the dialogue between companies and shareholders. We also argued in favour of an investor stewardship code, regrettably absent from the consultation and which we believe is the missing cornerstone of the 'comply or explain' principle currently applied in France on governance matters. As the use of share-based incentives was questioned in the consultation, we made a clear case in favour of a significant part of top executive remuneration being paid in shares, paid in instalments with performance criteria being applied, and there being a requirement to hold the shares over a long period of time. We see this as the most efficient tool to align company and shareholder interests over the long term. We will further contribute to the debate via discussions with stakeholders and articles.

Other public policy work this quarter included:

Promoting best practice

- As part of our ongoing work through the PRI on sustainability in the palm oil industry we spoke with representatives from Mars and M&S to discuss the challenges in securing supplies of certified sustainable palm oil.
- We spoke with the Carbon Disclosure Project and some consultants on the possibilities of examining discrepancies between corporate carbon reduction initiatives and policy lobbying.
- We actively participated in a lengthy meeting of the Canadian Coalition for Good Governance's pay subcommittee, which is working to enhance its policy guidance. Our specific recommendations included removing language endorsing the contention that there is a highly competitive market for executives as this may be seen as supporting high pay.
- We met with the Keidanren, Japan's dominant and influential business federation, which represents over 1200 companies and other organisations and which has conservative views about corporate governance. We discussed the lessons to be learned from the recent corporate scandals in Japan and their implications for the business sector generally.
- We met with the executive director of the Association of Capital Markets Investors to discuss governance and shareholder rights. The association is a non-profit organisation that aims to protect minority shareholders' rights in listed companies in Brazil.
- We met the local director of the Carbon Disclosure Project in China to discuss developments in the CDP's work in the country and progress by Chinese companies in their 2012

Public policy and best practice continued

responses. We discussed the challenges that CDP China faces when encouraging companies to participate.

- We met with the chair of the CityUK Russia Working Group to discuss its work alongside Moscow to create an international financial hub, the Moscow Financial Centre Initiative. The Russian government has identified TheCityUK as a leading partner in its work to develop Moscow in this way and we were invited to join the Russia & CIS advisory group and become part of one of their workstreams focusing on long-term sustainable investing.
- We spoke at the first ever Russian forum on ESG and responsible investment. We called for better disclosure and transparency on sustainability issues and stressed the need for Russian companies to integrate ESG as a core part of their strategy.
- We participated in the inaugural meeting of the Centre for Audit Committee and Investor Dialogue, a group we have initiated alongside other investors and one of the mid-tier audit firms to encourage dialogue between those who manage the relationship with companies' auditors and shareholders.
- In advance of our response to the Department of Business on its consultation on revised remuneration reporting regulations we met members of the GC100, a representative group of FTSE 100 general counsels, to discuss ideas on the consultation.

Public Policy

- We met with the chair and deputy chair of the International Auditing and Assurance Standards Board regarding their proposed reforms to the audit reporting standard. We welcomed the proposals as a first proper reflection by the Board of what we and other users have been calling for over the past several years – more informative audit reporting – and the Board acknowledged the role which our meetings have had in encouraging the standard-setter to make these proposals. We provided the first and the leading investor commentary at the IAASB's Brussels roundtable on its proposals for enhanced audit reports.
- We co-signed an investor statement in support of issuing a final rule on conflict minerals due diligence and reporting under section 1502 of the Wall Street Reform and Consumer Protection Act (usually known as the Dodd-Frank Act). The issuance of this rule is a significant milestone in our collective efforts to eliminate the link between violence and human rights abuse and the mineral trade in the Democratic Republic of Congo and surrounding countries.
- We had a group meeting with senior officials at Japan's Financial Services Agency responsible for corporate disclosure and securities exchange surveillance. We welcomed the recent introduction of a new regulation regarding capital raising, which is in line with the recommendations of a coalition of institutional investors including EOS.
- We met with the outgoing chair of the Comissão de Valores Mobiliários, the Brazilian Securities & Exchange Commission. We discussed the next steps to enhance regulation in Brazil, including the possible need to change company law to embed corporate governance requirements, provisions for related-party transactions and further requirements for board members and audit committees.
- We met with senior managers of the Taiwanese exchange's listing department to discuss its rules regarding audit committees, nomination processes and shareholder approval of transactions.
- We met with senior executives of the Brazilian Securities, Commodities and Futures Exchange to discuss financial regulations and listing rules. The different listing segments of the Exchange, the Novo Mercado in particular, have undoubtedly helped push companies to improve their corporate governance but there are still many areas where improvement is needed.
- We met with an MEP who is rapporteur for one of the key parliamentary committees responding to the EU Commission's proposals for enhanced audit rules. This means she is charged with developing the response which will shape the negotiation between the parties that will lead to compromise legislation.
- Following our response to a French securities regulator consultation on the dialogue between shareholders and companies, we are pleased that our views were quoted extensively in the final synthesis document which has recently been published.
- We were invited to speak at the Spanish Institute of Directors' conference on corporate governance developments in Spain, as well as the increased activism at shareholder meetings in Europe and Spain during the 2012 voting season.
- We responded to the Financial Reporting Council's consultation on the Stewardship Code. We welcomed the bulk of the proposals - many of which reflect our recommendations in an informal pre-consultation which preceded the formal process - as well as highlighting a few areas where we believe more work is needed.
- We attended the launch of the Kay Review final report. While there are elements of this that we are not wholly in agreement with and sections that we believe could go further, we agree with the overall focus and thrust of the document, much of which reflects our input over the review process.

Working with other shareholders

- We hosted a conference call with UNPRI members participating in the project on conflict minerals to present recent developments in the collaborative engagement effort we are leading focused on the sourcing of minerals from the Democratic Republic of Congo by electronics companies, and to coordinate the group's future activities.
- Following our meeting with the OECD's group of Middle East and North African heads of stock exchanges and securities regulators, we have held discussions with the OECD on our focus and priorities for the region. We recommended that it would be useful to develop a network of Middle East institutional investors who can meet to discuss corporate governance.
- We spoke with the director of the Russian Investor Protection Association to discuss corporate governance and shareholder rights. The Association is an independent, non-profit organisation and the only body in Russia established by investors to seek to enhance corporate governance in the country and to protect the rights of investors.
- We co-hosted a conference call with the other principal author of a set of guidance on South Africa's acting in concert rules, which have acted as a significant block on cooperation and collaboration between investors in the country.
- With a group of other UK investors we met representatives of the Investment Management Association and the Financial Reporting Council to discuss the proposed questionnaire for their 2012 Stewardship Code survey.

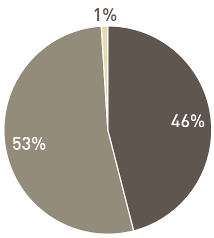
Hermes votes at general meetings wherever practicable. We take a graduated approach and base our decisions on annual report disclosures, discussions with the company and independent analysis. We inform companies before we vote against or abstain on any resolution, usually following up such votes with a letter. We maintain a database of voting and contact with companies and if we believe further intervention is merited, we include the company in our main engagement programme.

Hermes votes at company meetings all over the world, wherever its clients own shares.

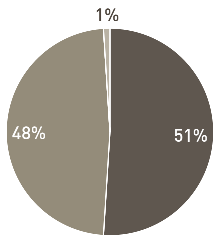
Overview

Over the last quarter, we voted at a total of 1,164 meetings around the world, analysing 9,433 resolutions. At 438 of those meetings we opposed one or more resolutions and we abstained at 15 meetings. We voted with management by exception at 11 meetings, while we supported management on all resolutions at 700 meetings.

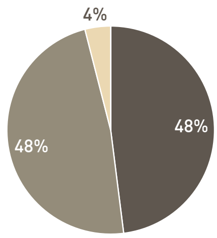
North America
We voted at 397 meetings (2,914 resolutions) over the quarter.



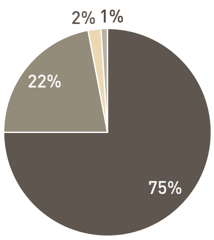
Asia Pacific
We voted at 110 meetings (734 resolutions) over the quarter.



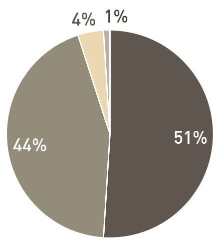
Australia & New Zealand
We voted at 33 meetings (143 resolutions) over the quarter.



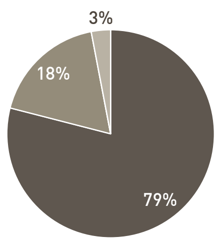
Emerging & Frontier Markets
We voted at 281 meetings (2,031 resolutions) over the quarter.



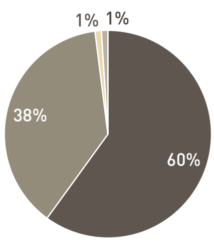
Europe
We voted at 134 meetings (1,080 resolutions) over the quarter.



UK
We voted at 209 meetings (2,531 resolutions) over the quarter.



Global
We voted at 1,164 meetings (9,433 resolutions) over the quarter.



- Total meetings voted in favour
- Meetings where voted against (or voted against AND abstained)
- Meetings where abstained
- Meetings where voted with management by exception

Important information

This communication is directed only at recipients who are eligible counterparties or professional clients. Any investment or service to which this communication relates is only available to and will only be engaged in with such persons and any other persons who receive this communication should not rely on or act upon this communication.

This communication is issued and approved only for the purposes of section 21 of the Financial Services and Markets Act 2000 by Hermes Investment Management Limited ("HIML").

Hermes is a multi-boutique asset manager, independent of any broader financial services organisation. Each Hermes operating entity is either a subsidiary of, or is otherwise affiliated to, Hermes Fund Managers Limited. They carry on business under the name "Hermes". The main operating companies within the Hermes Group are Hermes Investment Management Limited ("HIML"), Hermes Administration Services Limited ("HASL"), Hermes Equity Ownership Services Limited ("HEOS"), Hermes Focus Asset Management Limited ("HFAM"), Hermes Focus Asset Management Europe Limited ("HFAME"), Hermes Real Estate Investment Management Limited ("HREIML"), Hermes BPK Partners LLP ("HBPK"), Hermes Sourcecap Ltd ("HSL"), Hermes Fund Managers (North America) ("HFMNA") and Hermes Fund Managers (Australia) Pty Ltd ("HFMA"). All of the above named operating companies are separately authorised and regulated by the Financial Services Authority except for HREIML, HEOS, HFMNA and HFMA. HIML currently carries on all regulated activities associated with HREIML (which is not regulated) and is responsible for marketing HREIM products to prospective investors and for arranging their investment. HIML, HBPK, HFMNA and HSL are all registered investment advisers with the United States Securities and Exchange Commission (SEC). HFMA is registered with the Australian Securities and Investments Commission (ASIC) and holds Australian financial services license number 351784. HFMA is authorised to provide certain financial services to wholesale clients only.

Hermes Equity Ownership Services Limited ("HEOS") has its registered office at Lloyds Chambers, 1 Portsoken Street, London, E1 8HZ.

Please note that the Financial Services Authority does not generally regulate any activities referred to in this document which are not regulated activities under the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001.

This document has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient. This document is published solely for informational purposes and is not to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments. Prospective investors must rely on their own examination of the legal, taxation, financial and other consequences of an investment in the funds, including the merits of investing and the risks involved. Prospective investors should not treat the contents of this document as advice relating to legal, taxation or investment matters. Before entering into an agreement in respect of an investment referred to in this document, you should consult your own professional and/or investment advisers as to its suitability for you and should understand that statements regarding future prospects may not be realised. No action should be taken or omitted to be taken in reliance upon information in this document.

Figures, unless otherwise indicated, are sourced from Hermes.

This document may include a list of Hermes Equity Ownership Services Limited ("HEOS") clients. Please note that inclusion on this list should not be construed as an endorsement of Hermes Equity Ownership Services Limited ("HEOS") services. Should you wish to contact a client for reference purposes, please let Hermes know in advance.

CM110624 UK 10/12

Hermes Equity Ownership Services

Hermes Equity Ownership Services (HEOS) enables institutional shareholders around the world to meet their fiduciary responsibilities and become active owners of public companies. HEOS is based on the premise that companies with informed and involved shareholders are more likely to achieve superior long-term performance than those without.

Hermes EOS engagements with Lothian's top 10 holdings

Royal Dutch Shell As one of the leading international oil companies and one of the largest UK and Dutch listed companies we have engaged with the company over the past few years, in particular on risk management. Oil companies face a number of health and safety, environmental and reputational risks. Oil and gas reserves are increasingly found in developing countries which present additional political, human rights and other issues. There are also environmental risks associated with unconventional methods of oil and gas extraction from oil sands, arctic drilling and shale. Effective management of these risks requires appropriate governance. We have therefore engaged with the company on these issues. We will continue to push for further progress on our engagements through further contact with the company where we have good contacts. We will request a meeting with the corporate responsibility committee chair and write to the chair to suggest that the company report publicly on how it is trying to encourage the other Nigerian stakeholders to work with it to implement the other recommendations of the United Nations Environmental Programme's report into Ogoniland in Nigeria.

BHP Billiton BHP Billiton is a global operator in the high risk extractives industry, and over the past few years has attempted unsuccessfully a number of large transactions. Our engagement has therefore focused on ensuring the company adopts a strategy that focuses more on organic opportunities. We have also focused on the health and safety of both employees and contractors. Our engagement with the company has also been on oversight of risk, in particular in non-managed joint ventures. As with other extractives companies, BHP Billiton is more highly exposed to operational, as well as environmental and social risks through its joint-ventures due to lower risk management standards. An example of this is the Cerejon Coal mine in Colombia, which is jointly-owned by Anglo American, BHP Billiton and Xstrata. The Cerrejon Coal mine appears to operate with much lower risk management standards than any of the three minority shareholders apply to their own controlled operations. The aim of our engagement is to ensure that joint-ventures operate to the same standards as the company's own operations

HSBC Holdings As this is a large international bank our engagement in the past few years has focused on governance in the wake of the start of the global financial crisis in 2008. We have engaged on appropriate remuneration structures, seeking better alignment with long-term shareholder interests. Another focus has been appropriate management of risk, including how remuneration policy and risk management are linked. Much of the engagement is now largely complete; the new chair and CEO seem to be appropriate candidates and the apparently divided board seems to be working effectively under the new leadership. The chair has intimated some new refreshment of the NED contingent, including a possible successor to him as chair. The remuneration policy has also been radically revised with much of its success dependent on the appropriate use of discretion and dialogue with shareholders by the remuneration committee chair.

Vodafone Given Vodafone's global footprint and its investment in joint ventures our engagement to date has focussed on the benefits of its conglomerate structure and the company's strategy to unlock value from the sum of the parts. We have also discussed whether the company is getting full value for its brand and whether pricing is appropriate. We have also examined operational performance, including that of the supply chain as well as governance issues.

Rio Tinto Rio Tinto's presence in some of the most challenging operating environments has prompted our engagement activities to focus on how it manages environmental and social risks, as well as bribery and corruption risks The company's recent M&A activity has not been altogether successful and as a result, engagement has also focused on both management performance and the company's strategy. We have also engaged on risk management in its joint ventures. However the company faces a number of environmental and social risks which it does not appear at present to be managing sufficiently well. The company is particularly exposed to water risks. It has also suffered criticism over their minority interest in Grasberg copper JV with Freeport, which has poor operational record in terms of the environment and local communities. Grasberg is the most prominent example of how Rio Tinto is currently unable to ensure acceptable environmental and social risk management practices are employed in their non-managed joint ventures.

BP Post the Texas City explosion and the Prudhoe Bay oil spill we escalated our engagement and pushed for board refreshment, particularly at the chair, as we believed that this was the right way to ensure that the necessary cultural changes took place. We welcomed the appointment of the new CEO as we believed that he would focus closely on health & safety issues. The organisational changes he pushed through appeared to us as the right ones although, as time went on, we began to become concerned that the health & safety function within BP was becoming excessively decentralised and that no one was ensuring that lessons from one operation were learned across the entirety of the company's operations. We were obviously shocked and dismayed by the Macondo spill and explosion and stepped up our engagement again in the aftermath of this incident. Our recent engagement with the company has focused on its response to the accident in the Gulf of Mexico. We have held many meetings and participated in a number of telephone conversations with the company on both on how it has responded to the incident and also how it has reviewed and improved its risk management processes to minimise the likelihood of other incidents.

British American Tobacco The main focus of our discussions with the company have been on how it best navigates the difficulties presented by the tobacco industry. Additionally we have sought reassurance on the impact on the environment of its operations, in particular examining allegations of serious pollution, affecting the community local to its operations in one African country.

Nestle We have a long standing engagement with Nestle since 2005. Over the years we engaged on several issues such as Child labour in Africa, labour and bargaining right in emerging markets, unethical sourcing of palm oil and general governance issues. On the child labour issue, Nestlé has started to collaborate with local governments and producers to implement the Harkin Engel protocol. The aim being to complete a certification process by end 2010, effectively collecting data to assess the extent of the issue. Whilst Nestle has significantly improved its policies to deal with this issue, the lack of an effective monitoring of its supply chain creates a significant reputational risk for the company. Nestlé found itself also in disputes with unions over denial of bargaining rights and wages policy in several emerging markets. The most prominent dispute regards the workers who produce Nescafé products at the Panjang factory in Indonesia and it has been ongoing since 2008. On Governance, we have been engaging the company on governance issues since 2005. Over these years we have successfully encouraged, among other issues, the unbundled election of directors; the separation of the positions of chairman and CEO; the change of the terms of board members from five to three years; the removal of voting rights limitations, which were increased from 3% to 5% in 2008.

Unilever We engaged with Unilever since 2008. Our aim hereby is to ensure Unilever has sufficient oversight of its supply chains and conducts an appropriate level of audit to satisfy itself of its understanding. Interlinked to this engagement is the desire to explore the company's strategy for sustainable palm and soy sourcing. In term of Governance we would like to improve the alignment of variable pay of the board and other executives with interests of shareholders.

GlaxoSmithKline PLC The recent focus of the engagement has been on structural changes that have been necessary to support the company's cultural changes following substantial issues with its sales practices in the US. We discussed how the company can outwardly communicate the cultural shifts in its organisation and pressed that one number that will be picked up is the number of disciplinary actions over the year. This number remains high and we debated whether a sign of success is this number increasing or decreasing. We ran through the breakdown of these numbers, in particular focussing on those relating to falsifying documents, which represent 10% of the total issues. We further expressed a desire to see some regional breakdown of the figures to understand better how the trends vary across the globe. On Governance we pressure the company to better align pay to the risks and long term nature of the business. The Company assured us to amend the pay scheme further but we pushed for longer holding period of shares for the CEO at least to be more aligned with shareholders' experience of product lifecycles and as a risk management tool.

QUARTERLY ENGAGEMENT REPORT

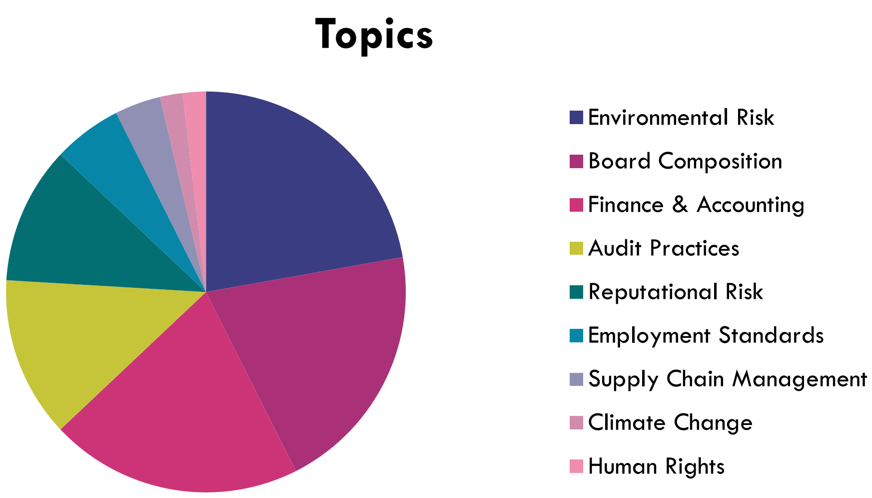
JULY TO SEPTEMBER 2012

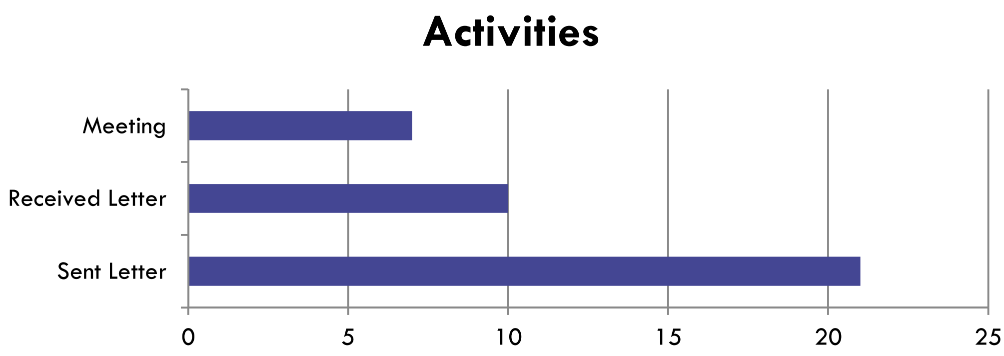
Local Authority Pension Fund Forum

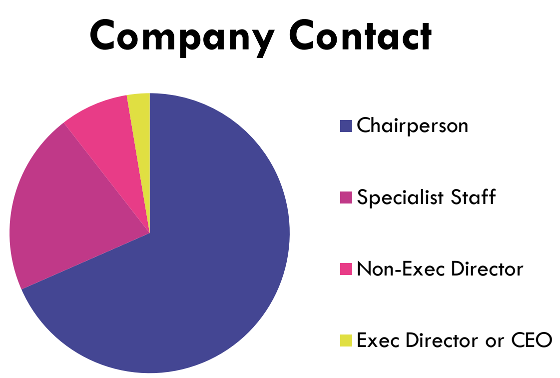
LAPFF exists to promote the investment interests of local authority pension funds, and to maximise their influence as shareholders whilst promoting social responsibility and corporate governance at the companies in which they invest. Formed in 1990, the Forum brings together a diverse range of 55 local authority pension funds in the UK with combined assets of over £115 billion.

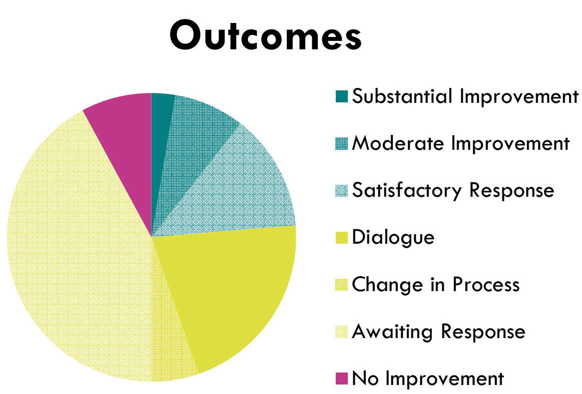
ENGAGEMENT SUMMARY

JULY TO SEPTEMBER 2012









ACHIEVEMENTS

- Met with directors at **Barclays**, **Lloyds**, **HSBC** and **Standard Chartered** directors to discuss IFRS, 'true and fair view' accounting, as well as recent fines and reputational risk in the banking sector.
- LAPFF member funds signed an open letter to Rupert Murdoch from Class A shareholders asking the **News Corp** board to appoint an independent Chair at its successor companies.
- Wrote to the Chair of **Lonmin** to express deep concern regarding violence at the company's South African platinum mine and to encourage the board to implement best practice principles in its relationships with police and security forces.
- Discussed sustainability and responsible supply chain management with **Kingfisher**, the parent company of household name B&Q. Met with **Reckitt Benckiser** on labour standards and supply chain management.
- Met with **Rolls-Royce** to discuss the company's role in reducing airline greenhouse gas emissions through improved jet engine technologies.
- Received responses from **EOG Resources** and **Wal-Mart** to the request that they participate in the CDP Water questionnaire. Both companies have declined to participate again this year. LAPFF also wrote to ten companies requesting they provide a response to the **Forest Footprint Disclosure** project.
- Sent letters to 36 companies in the FTSE 350 encouraging them to meet the **board diversity** targets set out by the Davies Review. We received responses from 12 companies on their measures to consider diversity in the boardroom.

THE FORUM IN THE NEWS

Investor calls for audit reform – Professional Pensions, 25 Sept

Local investment opportunities – AICIO, 20 Sept

News Corp shareholder resolution – Institutional Investor, 4 September, Telegraph, 5 September

Independent Chair at News Corp - BBC News, 18 July, The Telegraph, 18 July 2012, International Business Times, 19 July

Bob Diamond's Remuneration - The Guardian, 3 July

View more press coverage: http://www.lapfforum.org/press_coverage

COMPANY ENGAGEMENT

LEADERSHIP ON KEY CAMPAIGNS

Upon hearing of the horrific violence at **Lonmin's** West Markiana mine, LAPFF wrote to the Chair, Roger Phillimore, to express deep concern regarding the violence, asking the board to take due care in its relationships with police and security forces. The letter encouraged the company to refrain from issuing back to work orders to striking workers, for fear it would lead to more violence. It also asked the company to review community and workplace grievance mechanisms in light of the social unrest. The company responded swiftly to LAPFF's letter outlining its position with regard to the conflict. LAPFF was pleased to hear that the company has softened its stance; however tensions at the mine remain high and the company faces real financial risk.

PLATINUM FACTS

80% of world's platinum reserves are in South Africa

12% of global supply is produced by Lonmin mines

31% is used for catalytic converters

28% goes to producing jewellery

Members of LAPFF signed an open letter to **Rupert Murdoch** sent by 18 investors holding non-voting Class A shares and representing US $1.6 trillion in assets. The letter expressed the investors' support of the shareholder resolution filed by Christian Brothers Investment Services and co-filed by two LAPFF member funds requesting that News Corp appoint an independent chair. Class A shareholders do not have the right to file shareholder proposals or vote at the company's annual meeting. The LAPF chair met with UK investors to build support for the shareholder resolution and a webinar was held for US and other overseas investors.

Finally, LAPFF wrote to 36 companies on the FTSE 350 encouraging them to consider **diversity** when making appointments to the boardroom. To date, 12 companies have responded to the letter, highlighting the steps they are taking to implement the recommendation of the Davies Review which asks companies to achieve 25% women on the board by 2015. Many companies that responded highlighted their strategies to address diversity generally within the organisation, but there continues to be a serious disconnect between diversity in the workforce and diversity at the senior executive and director level.

PROMOTING GOOD GOVERNANCE

Financial Reporting & Audit

Criticisms of IFRS appear to be gaining steam as more investors and companies raise concerns about the distortive effects IFRS has on company balance sheets. LAPFF has initiated a round of meetings with the board chair or audit committee chair of each of the large

UK banks to discuss the Forum's concerns about accounting standards and the risk the standards pose to shareholder capital. This quarter, the Chair of LAPFF met with board directors and the finance directors of **Barclays**, **Lloyds**, **HSBC** and **Standard Chartered** to highlight the deficiencies in IFRS accounting and seeking each company's perspective on the issue. LAPFF has also arranged a meeting with **RBS**.

The Forum co-signed an investor letter to the **European Commission** (EC) on mandatory auditor rotation and recommended that auditors should not receive fees for non-audit services equal to more than 50% of the statutory audit fee to help avoid problematic conflicts of interest. The investor group also called for an investigation as to whether IFRS could provide a 'true and fair' view.

MANAGING ENVIRONMENTAL ISSUES

Environmental Risk Management

LAPFF is a long-term supporter of the **Forest Footprint Disclosure Project** and the **Water Disclosure Project**. This quarter the Forum wrote to 12 companies asking them to respond to these initiatives. Wal-Mart and EOG Resources replied to LAPFF's request stating that they did not intend to reply to the CDP Water questionnaire in 2012.

30 investors with assets of **US $2.5 trillion** signed up to the Forest Footprint Disclosure project in 2012

In March, LAPFF joined 35 other global funds, to write to **21 oil and gas companies** that are producing shale oil, asking for information about how much they are flaring and their plans to reduce flaring. Twelve of the 21 companies have responded, with a further three planning to do so. An investor webinar in September outlined potential follow-up investor engagement with these companies regarding flaring and other environmental risks related to shale oil.

A meeting with **Rolls-Royce** was very informative in explaining the company's technological approach to meeting demanding carbon reductions and its investment in newer technologies such as tidal power. The Forum expressed the view that the company could reinvigorate its message from the board on the strategic importance of carbon management to the business.

TARGETING SOCIAL ISSUES

Employment Standards & Sustainable Supply Chains

Meetings were held with **Reckitt Benckiser** and **Kingfisher** on the issue of sustainable supply chains and labour standards. Kingfisher, the parent company to UK 'do it yourself' chain B&Q described its recent Net Positive sustainability strategy which sets out a vision to not only 'do no harm', but to have a net positive impact on the environment. Kingfisher has set stringent

Kingfisher sold **7.1 million m^3** of timber products in 2011/12, roughly equivalent to the size of **Switzerland**.

-Kingfisher 2012 Sustainability Report

targets for sourcing sustainable timber, and for energy efficiency. The company has also recently improved its communication to shareholders about its sustainability initiatives and how they contribute to the bottom line.

The Forum's interest in meeting with Reckitt Benckiser was to learn from one of the market-leading companies on sustainability, how they integrate sustainability into the supply chain. LAPFF encouraged the company to continually improve its disclosure with regard to supply chain audit results and remediation practices.

In July, the Forum formally signed up to the **Access to Nutrition (ATN) Investor Statement**, following four years of engaging with UK companies on the investment risks posed by obesity. LAPFF's support for the initiative signifies the continued relevance of health and nutrition as an investor concern.

CONSULTATIONS & PUBLIC POLICY

ENGAGING POLICY MAKERS AND CONSULTATION RESPONSES

Following the publication of an SEC review of IFRS, LAPFF wrote to the **Office of the Chief Accountant at the SEC** to raise concerns about conflicts of interest within the IASB – the international body that sets accounting standards. The US has yet to adopt IFRS and is undertaking a review of the standards.

The Forum was represented in a meeting between several institutional investors and Senior Advisors at the **Bank of England** to discuss IFRS accounting at UK banks in July. The investors expressed serious reservations about the current accounting framework and advocated for a return to prudence and the 'true and fair view' in UK accounting. Representatives from LAPFF also met with the Department for Business Industry and Skills (BIS) and the Financial Reporting Council (FRC) to highlight concerns regarding inherent risks in IFRS accounting for institutional investors. The meeting was productive and LAPFF is working with other investors to further engage with key policy decision-makes on this issue.

LAPFF was also pleased to read that consultation responses submitted to regulators in Denmark have quoted the Forum's research into IFRS, highlighting the role the accounting standards played in the financial crisis.

No formal consultation responses were submitted by LAPFF this quarter. All consultation responses submitted by LAPFF to date can be viewed online at: http://www.lapfforum.org/consultations.

NETWORKS & EVENTS

- **News Corp:** webinar on shareholder resolution to appoint an independent chair
- **Oil sands** webinar on environmental & social risks by Ceres
- **30% Club** celebrates reaching over 50 Chairmen supporters
- **Food Ethics Council** Roundtable 'Overcoming commercial and political short-termism'
- **Integrated Reporting** webinar by Paul Druckmann, CEO, IIRC
- **UKSIF** annual lecture: Big Society Capital
- **Green Investment Bank** webinar by UKSIF & Transform UK

The Forum chaired a webinar to highlight the rationale for the shareholder resolution for an independent chair, and to debate wider concerns about the governance of News Corp.

The **30% Club** celebrated reaching over 50 FTSE 100 Chairman supporters in July. Attendees were advised of the progress of the initiative to date and of plans to develop the momentum behind this business-led approach to better balanced boards. Many board appointments have been to non-executive roles so it is intended to have a greater focus on the executive pipeline at companies.

LAPFF also participated in a **Ceres** webinar highlighting key social and environmental risks in the oil sands. Oil sands operating companies have recently set up an industry association to examine sustainability in oil sands operations and accelerate the pace of environmental improvement. The webinar outlined some practical steps companies can take to address issues such as water management, reclamation, biodiversity and greenhouse gas emissions. It also suggested how investors can engage with companies to encourage prudent environmental management in the extraction of oil sands.

The issues of commercial, political and consumer short-termism were debated at a **Food Ethics Council Roundtable** which explored key challenges faced by food businesses in progressing towards a sustainable food system and how this can be influenced by relevant players in the investment chain.

COMPANY PROGRESS REPORT

Company	Topic	Outcome
Archer-Daniels Midland	Environmental Risk	Awaiting Response
Ashtead Group	Board Composition	Moderate Improvement
Barclays	Finance & Accounting, Reputational Risk	Dialogue
Berendsen	Board Composition	Change in Process
Bunge Limited	Environmental Risk	Awaiting Response
Danone S.A.	Environmental Risk	Awaiting Response
EOG Resources	Environmental Risk	No Improvement
Fresnillo	Board Composition	Moderate Improvement
General Mills, Inc	Environmental Risk	Awaiting Response
Greggs	Board Composition	Satisfactory Response
Halfords Group	Board Composition	Satisfactory Response
Hikma Pharmaceuticals	Board Composition	Satisfactory Response
HSBC Holdings plc	Finance & Accounting, Reputational Risk	Dialogue
Intertek	Board Composition	Moderate Improvement
Kingfisher	Supply Chain, Employment Standards	Substantial Improvement
Kraft Foods Inc	Environmental Risk	Awaiting Response
Lloyds Banking Group	Finance & Accounting, Reputational Risk	Dialogue
Lonmin	Human Rights, Employment Standards	Awaiting Response
McDonald's Corporation	Environmental Risk	Awaiting Response
National Express	Employment Standards, Board Composition	Awaiting Response
News Corp	Board Composition, Reputational Risk	Dialogue
Olam International Limited	Environmental Risk	Awaiting Response
Reckitt Benckiser	Supply Chain Management	Satisfactory Response
Rolls-Royce	Climate Change	Satisfactory Response
Royal Bank of Scotland	Finance & Accounting, Audit Practices	Dialogue
Standard Chartered	Finance & Accounting, Audit Practices	Dialogue
Wal-Mart Stores Inc	Environmental Risk	Awaiting Response
Wilmar International	Environmental Risk	Awaiting Response
Xstrata	Board Composition	Change in Process
Yum! Brands Inc	Environmental Risk	Awaiting Response

Local Authority Pension Fund Forum

The Local Authority Pension Fund Forum was established in 1991 and is a voluntary association of 55 local authority pension funds based in the UK. It exists to promote the investment interests of local authority pension funds, and to maximise their influence as shareholders to promote corporate social responsibility and high standards of corporate governance amongst the companies in which its members invest. The Forum's members currently have combined assets of over £115 billion.

Report prepared by PIRC Ltd. for the Local Authority Pension Fund Forum

PIRC

www.lapfforum.org

Aberdeen City Council
Avon Pension Fund
Bedfordshire Pension Fund
Brent LB
Camden LB
Cheshire Pension Fund
City of London Corporation
Clwyd Pension Fund
Croydon LB
Derbyshire CC
Devon CC
Dorset County Pension Fund
Dyfed Pension Fund
Ealing LB
East Riding of Yorkshire Council
Enfield
Falkirk CC
Greater Gwent Fund
Greater Manchester Pension Fund
Gwynedd Pension Fund
Hackney LB
Haringey LB
Harrow LB
Hillingdon LB
Hounslow LB
Islington LB
Lancashire County Pension Fund
Lewisham LB
Lincolnshire CC
London Pension Fund Authority
Lothian Pension Fund
Merseyside Pension Fund
Newham LB
Norfolk Pension Fund
North East Scotland Pension Fund
North Yorkshire CC Pension Fund
Northamptonshire CC
NILGOSC
Nottinghamshire CC
Rhondda Cynon Taf
Shropshire Council
Somerset CC
South Yorkshire Integrated Transport Authority
South Yorkshire Pensions Authority
Southwark LB
Surrey CC
Teesside Pension Fund
Tower Hamlets LB
Tyne and Wear Pension Fund
Waltham Forest LB
Warwickshire Pension Fund
West Midlands Pension Fund
West Yorkshire Pension Fund
Wiltshire CC
Worcestershire CC

Pensions Committee

Tuesday, 18 December 2012

Class Actions

Item number	5.5
Report number	
Wards	All

Links

Coalition pledges	
Council outcomes	CO26
Single Outcome Agreement	

Alastair Maclean

Director of Corporate Governance

Contact: Marlyn McConaghie, Investment Analyst

E-mail: marlyn.mcconaghie@edinburgh.gov.uk | Tel: 0131 469 3518

EDINBVRGH THE CITY OF EDINBURGH COUNCIL

Executive summary

Class Actions

Summary

This report summarises activity on class actions.

A class action is when an investor agrees to act as a lead plaintiff in a case against a company. Typically, these actions happen in the US when a group of shareholders get together and sue a company to recover a loss in share value, or to exert influence on the company. A law firm fights the case on behalf of the class with the lead plaintiffs being treated as the representatives of the class. The cases can take several years to be heard by the courts and can be settled out of court. They are typically taken on a no win, no fee basis.

If a class action case is won, the compensation fund, net of legal fees approved by the court, is distributed to eligible shareholders who make a claim within the relevant time limit. Any shareholder that held shares during the class period is entitled to make a claim. The shareholders who lodge a claim share the compensation in proportion to the loss suffered. As shareholder, the Lothian Pension Funds make claims for compensation on all class action settlements.

In addition, the Lothian Pension Fund acts as lead plaintiff on a number of class actions, holding company management to account and aiming to deter future fraud and/or loss of shareholder value. This is consistent with its approach to environment, social and governance issues. Also, by acting as a lead plaintiff, the Fund may be in a position to influence the terms of the settlement. Summaries of the class actions where Lothian Pension Fund is acting as lead plaintiff are provided in the Appendix 1.

A court ruling in the case of Morrison vs. National Australia Bank (NAB) in 2010 appeared to narrow the ability of investors to seek redress under the laws of the US, particularly where shares are purchased out-with the US.

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

Financial Year	**US$ (000's)**
Prior to 31/03/10	1,614
2010/11	209
2011/12	317
2012/13 **[1]**	21
TOTAL [1]	**2,161**

[1]To 30 September 2012

There have been only three small settlements for the first half of this financial year. These relate to class actions against EADS, Qwest Communications and Royal Dutch Shell.

The Morrison vs. NAB ruling impacts on the Fund's ability to claim for compensation in the US. However there have been different interpretations of the ruling. It remains to be seen exactly how the Morrison vs. NAB ruling will be applied further. As a result investors are increasingly looking to obtain compensation through other jurisdictions where the legal process may require investors to "opt-in" to the case prior to the trial if they wish to participate. Lothian Pension Funds will consider the potential benefits and risks on a case by case basis.

Recommendations

It is recommended that the Pensions Committee note the content of this report.

Measures of success

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

Financial impact

US class actions are conducted on a no win no fee basis. In the event of a case being won, the courts approve the legal costs which are deducted from the compensation fund. The fund has recovered over $2bn in compensation from class actions.

Equalities impact

There are no adverse equalities impacts arising from this report.

Sustainability impact

Class action activity is undertaken as part of the Environmental Social and Governance (ESG) activity of the Fund which is expected to contribute to the sustainability of the Funds' investments.

Consultation and engagement

Regular updates on class actions have been provided to stakeholders.

Background reading / external references

Not applicable.

Links

Coalition pledges	
Council outcomes	CO26 – The Council engages with stakeholders and works in partnerships to improve services and deliver agreed objectives.
Single Outcome Agreement	
Appendices	Appendix 1 – Class Actions

APPENDIX 1 – CLASS ACTIONS

Summaries of the cases where Lothian Pension Fund's is currently acting as a lead plaintiff are outlined below:

- A case against Lehman Brothers is being progressed in relation to false financial statements and mismanagement at the company prior to the collapse of the bank. The case consists of separate claims against the directors, underwriters and auditors. The case was filed in 2008 and the estimated loss to the Fund is $4.7m. Shares were purchased in the US. In August 2011, the case against the company directors agreed a settlement of $90m. In May 2012 courts gave final approval to settlement of $90m with Lehman directors and officers and $426m with the underwriters. Litigation is ongoing with Lehman's accountants, Ernst & Young. The court may want to include this settlement with the others, which could delay settlement of the whole distribution. It is anticipated that settlement will be reached with Ernst &Young in first half 2013.

- A case against BP was lodged in 2008 in relation to the Prudhoe Bay oil spill in 2006 which caused an estimated loss to the Fund's shareholding of $0.4m. Shares were purchased in the UK. The case was dismissed in March 2012, partly due to the Morrison ruling, and also because of the specifics of the case. Legal advice was not to appeal, and the class action route is considered to be closed.

- The case against the pharmaceutical company Sanofi-Aventis was filed in 2007 and relates to misleading statements made by the company in relation to trials of a new drug, i.e. that the drug was testing successfully when in fact the Company was receiving definitive information to the contrary. The Fund is serving as co-Lead Plaintiff alongside a pension fund from the United States. The Fund's loss is estimated to be $1.5m. The plaintiffs filed for class certification in February 2012 and the defendant appealed. Plaintiffs have gone back to further support the motion for class certification. The court's ruling is pending.

- The Fund had an estimated loss of $2.0m due to holdings in the company Wyeth. The case is premised on Wyeth's (now Pfizer, as a result of a merger) misrepresentations of clinical trial results for the investigational Alzheimer's drug, bapineuzumab. The Fund was appointed co-lead plaintiff (along with Italian investment fund, Arca) in September 2010. In the summer of 2011, defendants moved to dismiss the case and were successful. An amended complaint was due to be heard by a magistrate in May 2012 but she cancelled the hearing and will decide the motion without argument. The motion is pending.

- The case against Genzyme was filed in 2009 and the Fund's losses are estimated to be $3.1m. The case relates to its failure to disclose serious issues at one of its manufacturing facilities that caused the company to halt production of two of its top selling drugs due to contamination. The case was dismissed. However an appeal was lodged, as new information became available. The result of the appeal is pending.

Pensions Committee

2pm, Tuesday, 18 December 2012

Regulatory Update including Public Service Pensions Bill

Item number	5.6
Report number	
Wards	All

Links

Coalition pledges	
Council outcomes	CO26
Single Outcome Agreement	

Alastair Maclean

Director of Corporate Governance

Contact: John Burns, Pensions & Accounting Manager

E-mail: john.burns@edinburgh.gov.uk | Tel: 0131 469 3711

Executive summary

Regulatory Update including Public Service Pensions Bill

Summary

This report provides an update on pensions regulations:-

- The draft Public Service Pensions Bill is making its way through the UK Parliament. It could have significant implications for Lothian Pension Fund.
- Scottish Government has consulted on changes to the regulations affecting the administration of Lothian Pension Fund.

Recommendations

Pensions Committee should note the regulatory update in this report, the significant implications for Lothian Pension Fund of the Public Service Pensions Bill and the tight timescales for implementation of a new LGPS in Scotland.

Measures of success

This report is purely advisory at this stage.

Financial impact

There are no financial implications arising directly from this report. Future legislative change to the design of the Local Government Pension Scheme, however, will have financial consequences for Lothian Pension Fund and participating employers. These are currently unknown and will be addressed in future reports to the Pensions Committee.

Equalities impact

There are no adverse equalities impacts arising from this report. Changes to the LGPS would be expected to be equalities tested by the Scottish Government.

Sustainability impact

There are no adverse sustainability impacts arising from this report. The Public Service Pensions Bill aims to make pensions more sustainable.

Consultation and engagement

Lothian Pension Fund is committed, on an ongoing basis, to keeping its employers and members fully informed of all the key developments on reform of the LGPS in Scotland. Regular bulletins have been issued to all employers, supplemented by meetings with senior management of certain larger employers. Pension reform also featured prominently as a topic in the Fund's Annual Employer Seminar, which was held on 6 December 2012.

Background reading / external references

The Public Service Pensions Bill and its progress through Parliament to eventual enactment can be viewed at http://services.parliament.uk/bills/2012-13/publicservicepensions.html.

Proposals for a new LGPS design in England and Wales can be viewed at http://www.lgps.org.uk/lge/core/page.do?pageId=15431012.

The response from the Scottish Pensions Liaison Group to the consultation on the draft Local Government Pension Scheme (Miscellaneous Amendments) (Scotland) Regulations 2013 is provided at http://www.lpf.org.uk/regs2013.

Report

Regulatory Update including Public Service Pensions Bill

1. Background

1.1 The Independent Public Sector Pensions Commission, chaired by Lord Hutton, published its report in March 2011. This report (the "Hutton Review") made a number of recommendations for fundamental change to UK public service pension provision.

2. Main report

2.1 The Public Service Pensions Bill ("the Bill") was published by the UK Government on 13 September 2012. The Bill passed its second reading on 29 October 2012. Should this Bill be enacted, then there would be significant changes required to the design and governance of the Local Government Pension Scheme (LGPS) in Scotland.

2.2 Specifically, the Public Service Pension Bill embodies the key recommendations of Lord Hutton's Independent Public Sector Pensions Commission, published in March 2011, namely:

- ♦ The end of final salary benefit arrangements;
- ♦ Retirement age linked to State Pension Age (SPA);
- ♦ Cost control system to provide affordability and sustainability;
- ♦ Measures to strengthen governance.

What does the Bill cover?

2.3 The Bill sets out a common framework for pension arrangements for the civil service, judiciary, local government, teachers, NHS, fire services, armed forces and members of the police.

Further detail as to the scope and provisions of the Bill is provided below:

Future service benefit structure

2.4 Although the actual design and benefit structure applicable to the individual public service schemes will be set out in regulations, the Bill confirms that any defined benefits under the new schemes must be provided on a Career Average Revalued Earnings (CARE) basis, a more detailed description from The Pensions Advisory Service is below from 2.5 to 2.7. Schemes (other than fire, police and armed forces), must also provide members with a normal pension age which is aligned to their state pension age or age 65 (whichever is higher). How the increase to members' state pension age is reflected in the individual schemes remains a matter for scheme regulations.

2.5 A career average revalued earnings (CARE) scheme is a type of defined benefit arrangement. It is set up by an employer to provide income in retirement for its employees.

2.6 Although the employer is responsible for sponsoring the scheme, it is run by a board of trustees (with the exception of most public sector schemes). The Trustees are responsible for paying retirement and death benefits.

2.7 Members contribute to the scheme with the promise of a certain level of pension. The amount of pension payable is dependent upon:

- the length of time served in the scheme (known as pensionable service);
- career averaged earnings [* see below]; and
- the scheme's accrual rate. The accrual rate is the proportion of salary that is received for each year of service.

  * A career average scheme matches each year's benefit accrual to earnings in each year rather than the final years' earnings. The earnings figure will be uprated in line with prices rather than the actual increase in earnings.

  For example, if the scheme provides a pension calculated as 1/60 of pay for each year of service and the member retires in 2010 with 30 years' service, then to calculate pension, each year's pay will be uprated with inflation and then aggregated. It will then be divided by 30 to provide the "average" pay, which in the example would be multiplied by 30/60 to arrive at the pension.

Closure of current schemes

2.8 The Bill provides that the existing schemes will be closed to future accrual with effect from 5 April 2015 (or 1 April 2014 in the case of the LGPS in England and Wales). It also addresses certain transitional issues.

2.9 In particular, the Bill enables schemes to provide that members who are a certain number of years from their normal pension age on 1 April 2012 will not see any change to their retirement age, or any decrease in the amount of pension they receive on retirement. In addition, the benefits which will have accrued in the current scheme will continue to be linked to his/her final salary when they eventually leave continuous service.

Capping costs

2.10 One of Lord Hutton's key recommendations was a scheme-specific mechanism to ensure costs are kept below specified levels. The basis for such an "employer cost cap" is set out in the Bill, with the intention being that HM Treasury will make regulations to amend schemes where necessary to keep costs within the set margins.

2.11 The Bill further envisages HM Treasury issuing directions as to how valuations are undertaken by the schemes, including when setting the employer cost cap. LGPS funds have not previously had such oversight from HM Treasury when completing their triennial actuarial valuations. CIPFA has already expressed its criticism of this specific proposal.

Governance

2.12 The Bill also sets out new provisions for the overall governance and regulation of the public service pension schemes.

2.13 Each scheme will have its own 'manager' with responsibility for scheme administration, together with a pension board to assist the manager. The remit of the pension boards will be to ensure compliance with legislation, codes of practice and regulatory issues.

2.14 Until now, there has not been a body responsible for the overall regulation of all public service pension schemes. The Bill, however, extends the Pension Regulator's remit to all public service schemes. Accordingly, the Pensions Regulator will be able to issue codes of practice in respect of the public service schemes and require scheme managers to implement internal control procedures in respect of the administration and management of the schemes.

Access to public service pension schemes

2.15 The Bill contains provision which will enable public service pension schemes to allow non-public service workers to participate in the scheme. This reflects the scope for private sector contractors to be admitted to the public service schemes. Again, the detail and terms on which this will be permitted will be a matter for individual scheme regulations.

Timescales

2.16 The Government has indicated that the reforms to public service pension schemes constitute a settlement for a generation. As a result there is a protected period of 25 years from 1 April 2015 during which changes cannot be made, for example, to benefit accrual or contribution rates unless there is consultation with affected persons with a view to reaching agreement on the changes. Importantly, this procedure does not apply where changes are needed to keep the schemes within the employer cost cap.

2.17 This is a very significant Bill which will put Lord Hutton's recommendations onto a statutory footing. The Bill is expected to work its way through the UK Parliament before being enacted sometime during 2013. Individual schemes will then issue the regulations specifying benefit structures and governance arrangements ahead of the latest commencement date for the new schemes – being 6 April 2015 (or 1 April 2014 for the LGPS in England and Wales).

Reform of the LGPS in England and Wales

2.18 Proposals for a new LGPS design in England and Wales have already been published. Consultation responses from the Local Government Association (LGA), UNISON, GMB and Unite have endorsed the proposals for a reformed LGPS and approval by the Government is expected shortly.

LGPS in Scotland

2.19 Pensions policy is a reserved matter for the five main public sector pension schemes, including the LGPS in Scotland. Once enacted, the Public Service Pensions Bill would become primary legislation. Scottish Ministers have been given 'executive devolved competence' to determine scheme specific regulations for the LGPS in Scotland. These regulations, however, must comply with UK legislation.

2.20 Initial meetings of the Scottish Local Government Pensions Advisory Group (SLOGPAG) have been held to consider the implications of the Bill and address future reform requirements. SLOGPAG has tripartite representation from the Scottish Government, Trade Unions and CoSLA, supplemented by pension manager support.

2.21 Unison has stated that it has obtained legal advice that the Bill would require a Legislative Consent Motion (LCM) in the Scottish Parliament in order to change the LGPS. Scottish Government officials have asserted that this is not the case.

2.22 The timeframe for implementation of a new scheme design by the Bill deadline of April 2015 is extremely tight. The Scottish Government has indicated that it is hopeful that the requisite negotiation, regulation writing and pre-implementation preparation phases could run concurrently, to a certain degree, but this is by no means guaranteed.

Regulatory Update – General

2.23 In October 2012, the Scottish Public Pensions Agency (SPPA) issued for consultation the draft Local Government Pension Scheme (Miscellaneous Amendments)(Scotland) Regulations 2013. The main changes relate to the Annual Allowance (Scheme Pays option) and to the alignment of the LGPS regulations with Auto-Enrolment pension legislation. Other proposed amendments should serve to clarify the interpretation of existing provisions.

2.24 A response to the consultation, on behalf of all the LGPS administering authorities in Scotland, has been submitted by the Scottish Pensions Liaison Group. This is available on the Lothian Pension Fund web-site, through the hyperlink provided below at "Background reading / external references".

3. Recommendations

1. Pensions Committee should note the regulatory update in this report, the significant implications for Lothian Pension Fund of the Public Service Pensions Bill and the tight timescales for implementation of a new LGPS in Scotland.

4. Background reading / external references

The Public Sector Pensions Bill and its progress through Parliament to eventual enactment can be viewed at http://services.parliament.uk/bills/2012-13/publicservicepensions.html.

Proposals for a new LGPS design in England and Wales can be viewed at http://www.lgps.org.uk/lge/core/page.do?pageId=15431012.

The response from the Scottish Pensions Liaison Group to the consultation on the draft Local Government Pension Scheme (Miscellaneous Amendments)(Scotland) Regulations 2013 is provided at http://www.lpf.org.uk/regs2013.

Alastair Maclean

Director of Corporate Governance

Links

Coalition pledges	
Council outcomes	CO26 – The Council engages with stakeholders and works in partnerships to improve services and deliver agreed objectives.
Single Outcome Agreement	
Appendices	

Pensions Committee

2pm, Tuesday, 18 December 2012

Service Plan 2012 -2015 - Monitoring Update

Item number	5.7
Report number	
Wards	All

Links

Coalition pledges	
Council outcomes	CO26
Single Outcome Agreement	

Alastair Maclean

Director of Corporate Governance

Contact: Carole Thomson, Development Manager

E-mail: carole.thomson@edinburgh.gov.uk | Tel: 0131 529 4662

Executive summary

Service Plan 2012 - 2015 - Monitoring Update

Summary

Progress against the objectives agreed in the 2012-15 Service Plan is detailed in Appendix 1. Overall, objectives are being achieved. The following are of particular note:

- 99% of active members' annual benefits statements were provided on-line and notifications issued to members;
- Completion of the governance review;
- Changes made to processes, and support and guidance to employees, in relation to auto-enrolment.

In addition to progress against Service Plan, Lothian Pension Fund and Lothian Buses Pension Fund have been shortlisted in the Local Government Chronicle Awards.

Appendix 2 shows the targeted Performance Indicators for the 2012-2015 Service Plan and actual performance against these targets.

A summary of the projected financial outturn for 2012/13 in the table below.

	Approved Budget	**Actual Outturn**	**Actual Variance**
Category	**£'000**	**£'000**	**£'000**
Employees	1,914	1,875	(39)
Transport	27	23	(4)
Supplies & Services	864	833	(31)
Investment Managers Fees	10,284	9,300	(984)
Other Third Party Payments	349	410	61
Depreciation	44	44	-
Direct Expenditure	**13,482**	**12,485**	**(997)**
Allocated Central Support Costs	**702**	**702**	**-**
Income	(884)	(904)	(20)
Total Cost to the Funds	**13,300**	**12,283**	**(1,017)**

The key variances against budget are:-

- Employees - £39k underspend. This is mainly due to unfilled posts across division (£128k underspend), temporary agency costs (£37k overspend) and retirement costs (£52k overspend).
- Investment management fees – £984k underspend. This is primarily due to the termination of active currency overlay contracts.
- Third party payments - £61k overspend. This is due to Northern Trust accounting fee, which had not been budgeted for.

Recommendations

It is recommended that Pensions Committee notes the progress made against the service plan.

Measures of success

The performance indicators shown in the Appendix show the progress and success against the Service Plan.

Financial impact

There are no direct financial implications related to this report. The budget monitoring shows an underspend of approximately £1m.

Equalities impact

No full equalities impact assessment is required.

Sustainability impact

No full sustainability impact assessment is required.

Consultation and engagement

Customer insight and consultation informed the priorities of the service plan.

Background reading / external references

Not applicable.

Links

Coalition pledges	
Council outcomes	CO26 – The Council engages with stakeholders and works in partnerships to improve services and deliver agreed objectives.
Single Outcome Agreement	
Appendices	1 - Lothian Pension Fund Service Plan 2012-2013 2 - Lothian Pension Fund Performance Indicators

Appendix 1

Lothian Pension Fund Service Plan 2012-2013

Generated on: 20 November 2012

1. Provide Excellent Customer Care

Priority Outcomes	Action	Progress	Due Date
Improve insight into our customers' needs and experiences	Contact customers (on a sample basis) for their views on our service following receipt of service. Publish results and action taken. Engage with customers using Customer Journey mapping to reveal opportunities for service improvements.	Mystery shopper exercises and surveys being carried out. (see performance indicators) Improvement made to the transfer in process, we now give new scheme members with previous pension rights the option to defer a transfer decision and send them a reminder three months before their deadline expires. A recent remapping exercise demonstrated that this customer groups needs are now being met. We also engaged with the recently bereaved to complete a Customer Journey Map. As a result we have reviewed and amended our communications.	31-Mar-2013
Improve communication with members and employers	Advising of any changes, including consultations on proposals, to the benefit structure and contributions of the Scottish LGPS.	Recent news of Pensions Bill communicated to members on website and employers via e-mail and face to face briefings.	31-Mar-2013
	Continue to develop the Fund's website to improve functionality for users and ensure information is up to date. We are currently working on adding video content.	The website is continually reviewed and updated. We added video content to help members register for member self-service.	
	Implement 'employer on-line' access, thereby facilitating up to date records through electronic transfer of information in standard formats.	System procured. A project plan has been agreed to implement and roll out to employers, with the larger employers being prioritised. The roll out to smaller employers will take place in 2013/14	
	Promote the benefits of LGPS membership to active members and employees, thereby enhancing the sustainability of the scheme	In conjunction with Prudential, one of our in-house AVC providers, a mailing was sent to active scheme members over the age 45 to promote the benefits of LGPS membership. Auto enrolment starts in 2013 and this is expected to increase membership. Support where possible is being provided to employers for auto enrolment. Opt out communications have been reviewed.	
	Provide pension clinics at selected employer locations by utilising the web-based pension administration system	A project team has been set up to take pension's clinics forward. However, due to staffing issues full rollout of pension clinics are currently on hold. A briefing on the scheme for union shop stewards in Edinburgh was held in October.	

Appendix 1

Priority Outcomes	Action	Progress	Due Date
Improve access to personal information through website or via telephone	Further promoting the 'My Pension' personal access to information through secure web based 'member on-line' system.	Following the launch in September 2011 member on-line has been further promoted through annual newsletter and natural workflow e.g. telling scheme members about it when they contact us by telephone, in writing or face-to-face enquiries.	31-Mar-2013
	Provide all Annual Benefit Statements from now on electronically unless the member has previously expressed a preference for continuation of paper format.	All 28,000 active members annual benefit statements were online by 31 August 2012. We issued a newsletter including their activation code or username reminder by the end of September 2012. 600 paper forecasts were sent by end of October 2012. In July 2012, all deferred benefit statements were available on the site. 8,000 deferred members were sent an annual newsletter including an activation key to view their annual benefit statements electronically. The remaining will be sent by the end of November 2012.	
Improve Service delivery	Monitor service standards per the Pension Administration Strategy at both Fund and selected individual employer level, including Partnership Agreements and liaise with employers to improve performance.	Performance reports have been issued to employers. Improvement meetings have been held with Large Employers.	31-Mar-2013
Maintain Customer Service Excellence accreditation	Ensure that we continue to improve our services by directly involving our customers.	Lothian Pension Fund continue to work on service improvements identified from customer feedback including employer on-line, member self service and how we process workflow within pensions administration. The CSE assessment takes place in January 2013.	31-Mar-2013
Tailor service to customer needs - employers	Tailor service to customer needs - employers	Options for bespoke investment strategy are now being offered to employers	31-Mar-2013
Tailor service to customer needs - members	Tailor service to customer needs - members	Aligns with CSE above.	31-Mar-2013
Ensure LPF's compliance with the statutory obligations of auto-enrolment provisions	Revise LPF documentation and procedures to take account of the new statutory auto-enrolment provisions	Meetings have been held with the largest employers to discuss introduction of auto-enrolment. Draft guidance from the Local Government Employers association has been circulated. Opt out process has been amended	31-Mar-2013
Deliver an excellent service to Falkirk Council	Ensure standards of customer service excellence are maintained in respect of the Falkirk Council Pension Fund Service Level Agreement	Lothian Pension Fund is supporting Falkirk Pension Fund. Training of elected members took place in August and quarterly meetings began in September. Regular meetings with their Investment Managers being held.	31-Mar-2013

Appendix 1

2. To Support and Develop Staff

Priority Outcomes	Action	Progress	Due Date
Empowering and motivating staff to provide excellent customer service and improve performance	Carry out Staff Survey improvement plans and involve staff in improvement projects	Business Process Review also underway in pensions administration to improve workflow. Staff Survey improvement plan has been updated following 2012 survey. Focus will be on communication, trust with line managers, empowering staff to make improvements and personal development. Remit of Staff Forum is being clarified to improve its effectiveness. Teams of pensions administration staff recently reorganised to improve accountability and consistency.	31-Mar-2013
Enhance staff feedback systems	Facilitate the regular Staff Engagement Forum and ensure staff contributions are recognised both formally and informally. The Investment & Pensions Service Manager also hold a regular surgery for staff to raise any issues on a confidential basis.	Staffs views and suggestions are encouraged at team meetings. The Services Manager holds monthly one-to-one surgeries to enable staff to raise any confidential issues and is also meeting with small staff groups.	31-Mar-2013
Develop staff	Ensuring staff are provided with career and personal development opportunities	A skills audit is being issued to staff on a phased basis to help identify and implement career and personal development opportunities. A training matrix has been developed and is being rolled out for Pension Assistants. Career aspirations and personal development plans are discussed and agreed at the annual PRD meeting.	31-Mar-2013
	Improving staff training by implementing the core competency, skills and knowledge framework	Aligns with above.	
	Providing shared file and e-access to procedure manuals and training material	Procedure manuals are in place and are reviewed periodically. Revised investment accounting functions are currently being put in place following the custodian taking on the accounting of investments and manuals will be updated to reflect new processes and controls.	
Ensure clear communications of goals and expectations	Provide clear objectives at annual appraisal meetings and review progress, in accordance with the Council's staff management policies and procedures.	All staffs half-year PRDs have been completed. Performance objectives have been set for all staff. Managers aim to meet with staff individually and as a team on a monthly basis.	31-Mar-2013
Support staff through change programmes	Ensure regular communication of change projects such as departmental structure changes, shared services, ICT developments, scheme and governance reviews.	A monthly verbal update is provided to all staff by the Services Manager which is also summarised in an e-mail.	31-Mar-2013
Ensure staff are informed of LPF's progress, performance and achievements	Provide regular DMT update sessions on key performance elements and topics.	Monthly performance and quarterly service plan updates are provided to all staff via covalent web link. Updates are also provided to staff at meetings.	31-Mar-2013

Appendix 1

3. To continue to be a top performing pension fund			
Priority Outcomes	**Action**	**Progress**	**Due Date**
Provide an efficient, accurate and effective service	Continue to improve the quality of pension administration data and ensuring compliance with best practice as defined by the Pensions Regulator.	Ongoing data cleansing continues with measurement later in the year. The monthly reconciliation of pension payments is ongoing.	31-Mar-2013
	Explore the potential for further service efficiencies by the greater use of electronic communications (e.g. beneficiary nominations etc).	Electronic communications is being explored in the workflow BPR currently taking place. e.g. sending member communications via member self service. Also aligns with employer on-line.	
	Monitor the performance standards specified in the Pension Administration Strategy and take appropriate action thereon.	2011/12 performance reports have been issued to employers and improvement meetings held. Reports to 30/09/2012 are being prepared.	
	Revise the LPF organisational structure and budget to accord with integrated pensions payroll provision and initiate implementation project (target date for implementation to be determined in consultation with ICT supplier).	Meetings have taken place with HR and payroll management, in order to formalise Terms of Reference and Protocol. Contract with the payroll supplier has been signed, with 8 months implementation programme scheduled to commence in January 2013.	
Continue the programme of business process reviews	Use business process reviews to improve efficiency and service to customers.	A "pension administration workflow" BPR is in underway to help us to identify how we can work more effectively, thus improving performance and our service to our customers. Several suggestions made have been introduced already eg changes to auto-task assignment	31-Mar-2013
Annual Report – attain an unqualified audit opinion	Improve quality of accounting records, including ensuring consistency in validation of investment valuations and data reconciliations (e.g. contributions receivable).	Revised procedures have been implemented during the year end accounting.	30-Sep-2012
Undertake strategic investment review and further utilise investment management skills	Review the investment strategies of the Lothian Pension Fund, Lothian Buses Pensions Fund and Scottish Homes Pension Fund - investigate options for the internal investment team to enhance performance and manage investment risks.	Complete Implementation of revised strategies will be taken forward by Investment Strategy Panel.	31-Mar-2013
Risk is managed effectively	Review risks regularly. Review and strengthen internal controls, specifically relating to investment	Risk, compliance and internal controls are reviewed each quarter. Procedures and segregation of duties exists to ensure that funds are managed in adherence to guidelines and objectives. A review of investment risk including FSA regulations and industry best practice to identify improvements is planned in the near future. Recruitment for internal lawyer is progressing.	31-Mar-2013
Continue to support external change	Contribute as appropriate to any Scottish Government consultation on matters affecting the Scottish LGPS. Contribute to the pensions industry in general.	Participating in Scotland's tri-partite group discussing the Pensions Bill and scheme reform.	31-Mar-2013

Appendix 1

Priority Outcomes	Action	Progress	Due Date
Monitor the employer covenant to the Fund	Monitor the risk profile of the participating employers.	Review of employer covenant to the Fund has been undertaken as part of the Actuarial Valuation 2011 and monitoring of risk exposure is ongoing. Guarantees for new admitted bodies being pursued with suitable bodies.	31-Mar-2013
Ensure Fund's continuing ability to meet its liabilities	Strengthen cash-flow forecasting by the use of detailed financial modelling techniques, recognising the context of employer workforce strategies.	Cash flow projections have been considered during Investment Strategy Review. Initial liaison undertaken with Hymans Robertson to develop model for future use.	31-Mar-2013
Secure procurement efficiencies	Contribute to collaborate procurement initiatives, including exploring the potential for joint Framework Agreements for a range of services.	Collaboration between pension funds is ongoing. Individual Scottish funds have agreed to give access to new contracts to other Scottish funds. Joint project on member tracing provider.	31-Mar-2013
Strengthen governance	Review the governance and audit scrutiny arrangements of the Fund, taking cognisance of best practice (e.g. independent observer) and regulatory guidance.	Independent Professional Observer underway. Update on Governance Review being reported to committee in December 2012	31-Mar-2013
Provide for ongoing contribution stability	Liaise with the Fund's actuary to propose a contribution stability mechanism beyond the actuarial valuation 2011.	Work will be scheduled for 2013 to meet target date of March 2014 ahead of 2014 actuarial valuation.	31-Mar-2013

Appendix 2

LPF Performance Indicators

1. Provide Excellent Customer Care

Code	Indicator	Q1 2012/13	Q2 2012/13	Q3 2012/13	Q4 2012/13	Current Target
		Value	Value	Value	Value	
LPF:CF1	Customer satisfaction with communication (12 month rolling period)	90.58%	85%			85%
LPF:CF2	Annual Benefit Forecast - Active	99.5%				95%
LPF:CF3	Improve service to members: maintain CSE	Current CSE Assessment will take place in January 2013				Yes
LPF:CF4	Customer satisfaction with communication (12 month rolling period)	83.48%	85%			85%

2. To Support and Develop Staff

Code	Indicator	Q1 2012/13	Q2 2012/13	Q3 2012/13	Q4 2012/13	Current Target
		Value	Value	Value	Value	
LPF:SF1	Monthly Level of Sickness Absence	4.58%	6.82%			4%
LPF:SF2	To improve staff satisfaction (annual survey)	53%				55%
LPF:SF3	Improve staff development - annual training requirement > 15hrs training per member of staff	6.65	2.9			3.75

Appendix 2

3. To continue to be a top performing pension fund

Code	Indicator	Q1 2012/13	Q2 2012/13	Q3 2012/13	Q4 2012/13	Current Target
		Value	Value	Value	Value	
LPF:PF1	LPF - 3 year annualised investment return compared with benchmark	-0.12%	0.16%			1%
LPF:PF2	Pension Admin Cost per member	£23.86	£24.41			£24.01
LPF:PF3	Pension Admin Workflow - Key Tasks	95.19%	93.4%			90%
LPF:PF4	Employer contribution paid within 19 days of month end	99.39%	99.73%			95%
LPF:PF5a	Data quality: new data post June 2010	Not measured for Quarters				100%
LPF:PF5b	Data quality: old data pre June 2010	Not measured for Quarters				96%
LPF:PF5c	Data quality: conditional and numerical data	Not measured for Quarters				98%