

# Pensions Committee

2.30pm, Monday, 24 March 2014

## Investment Controls and Compliance

Item number	5.4
Report number	
Wards	All

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# Executive summary

## Investment Controls and Compliance Policy

### Summary

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The Lothian Pension Fund's internal investment team currently manages approximately £2.8 billion of the collective investments of the pension funds administered by the City of Edinburgh Council. We have therefore looked to review and develop the operational procedures of the investment team in order to ensure that it continues to act in compliance with any applicable law or regulation and, where such law or regulation is not necessarily applicable to us, complies with industry best practice for equivalent fund management operations in the private sector.

This report:

1. Highlights the existing compliance policies and procedures.
2. Provides details of a review of the operations of the in-house investment team carried out by an external consultant.
3. Proposes that the investment team seek authorisation from the Financial Conduct Authority (FCA) in order to further strengthen controls.

### Existing Compliance Procedures

The Fund has a compliance policy which documents key controls. The policy covers all operations of the Fund including governance, internal and external investment management arrangements, accounting and pension administration. Each quarter, managers review the implementation of controls, sign-off compliance/report any breaches and highlight new risks.

The policy has evolved over time and a comprehensive review has been undertaken following the appointment of the Legal & Risk Manager in March 2013. Additional controls and checks have been incorporated particularly in relation to our wider legal and regulatory obligations (Freedom of Information, Financial Services and EU regulation etc.). This review has been carried out in tandem with the regular updates of the risk register

The Fund's compliance procedures and controls are subject to regular review by internal audit. They were also reviewed recently as part of a risk assurance project carried out across the City of Edinburgh Council. The Fund's controls were deemed to provide good levels of assurance.

The Fund has also been engaging with its investment managers and custodian in relation to compliance with the European Market Infrastructure Regulation (EMIR), which now regulates the foreign exchange contracts and other derivative investments (e.g. futures, foreign exchange forward contracts). To facilitate our compliance with these new regulations, we are now registered with the FCA for the purposes of notifying it of certain EMIR events and have appropriate systems and procedures in place to ensure such notifications are made.

### **Investment Team Operational Review**

An external consultant (Mercer) recently reviewed the investment operations of the Fund particularly relating to the internally managed investments. The review considered our governance and organisational structure, team size and adequacy, compliance processes and controls and investment systems (including transaction execution, valuation and administration) by comparison to industry best practice in the private sector, but also in the context of the structure of a local government pension fund.

The review concluded that our existing systems and controls are generally sufficient for the Fund's current investment activity. The key recommendations of the report were as follows:

- **Dedicated front office systems:** a dedicated front office portfolio management system (in relation to reviewing, managing and confirming portfolio/stock details, trades etc.) would be required in the event of increased investment activity.
- **Operational due diligence on custodian and external investment managers:** we currently carry out regular reviews of our underlying investments and periodic reviews of our custodian and external managers. The consultant recommended more detailed and regular operational review of our providers' systems and their alignment with our own/our requirements.
- **Staff remuneration and retention:** the review identified that we do not externally benchmark salaries and that the notice period provisions in our staff contracts were not in line with market practice for the relevant roles. The consultant also noted that the Fund adheres to wider Council Human Resource (HR) policies and procedures but ideally special arrangements should be made for key staff to mitigate this risk.

The review provided guidance on other improvements which could be made to controls, including those which should be considered if the Fund increase its activity, for example either increased volumes of trading and/or to achieve the operational best practice or if any regulated investment activities were undertaken.

The recommended improvements are being considered by the Fund. We are also liaising with the Council's HR team to consider the possible options to address the HR risks identified by the consultant.

The Fund is considering how to take forward the recommendations and it is anticipated that all will be implemented unless considered to be resource-intensive and/or add little value to the Fund's controls. Some of the recommendations have already been implemented.

A copy of the full report has been circulated to the Convener of the Pensions Committee, the Convener of the Pensions Audit Sub-Committee, the Independent Professional Observer and the Investment Strategy Panel.

### **FCA Authorisation**

We have carried out detailed analysis in relation to the Fund applying for authorisation by the FCA.

Authorisation by the FCA would facilitate improved governance of the investments of the Fund as well as enable more effective sharing of services with other local authority pension funds which would allow us to potentially generate meaningful cost efficiencies. It might also mitigate the risk of staff retention within the investment team, in facilitating a positive long term strategy which makes best use of in-house resource and provides further opportunity to develop this function. Structuring the investment function of the Fund in a manner that would support FCA authorisation has also been identified as an appropriate development for us during the course of the recent review of our investment operations by the external consultant.

FCA authorisation does bring with it financial, legal, resource, compliance and other implications on an ongoing basis. These should be justified in the context of the development of the Fund and the savings in external investment fees which have been generated as a result. However, the Fund has an experienced investment and legal team and so is already relatively well placed to implement and maintain FCA authorisation. Additional resource of £50K per annum has been included in the draft budget for 2014-17 for which Committee's approval is sought (this is covered elsewhere on the agenda). This includes a non-refundable application fee for FCA authorisation in the region of £5,000, with an annual levy of less than £5,000. Other indirect compliance and administrative costs have been allowed for, including adding one member to the internal compliance team.

FCA authorisation would also require the City of Edinburgh Council to establish a separate corporate vehicle for the purpose of operating the investment functions of the Fund. This vehicle would apply for FCA authorisation and take all necessary action to ensure ongoing compliance with the applicable FCA Rules and associated regulation.

An application to the FCA which would need to include, among other things, a realistic and achievable business plan that anticipates an arrangement that would require us to become FCA authorised. The development of our arrangements with other local authorities, currently being structured through a shared services approach and restricted due to our inability to provide investment advice to third parties, would constitute the basis for our business plan.

The process of FCA authorisation itself should not be unduly onerous but would involve preparatory work by the Fund. The FCA would then have to consider the application, which could take between 6-12 months. Updates will be provided to Committee as work progresses to gain authorisation.

A copy of our detailed analysis on the process and implications of FCA authorisation has been circulated to the Convener of the Pensions Committee, the Convener of the Pensions Audit Sub-Committee and the Independent Professional Observer.

## Recommendations

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The Committee are recommended to:

- note the ongoing review and update of our Compliance Procedures;
- note the headline recommendations of the investment operations review and actions being taken to address the risks; and
- approve the proposal to proceed with FCA authorisation and to note that progress will be provided to Committee.

## Measures of success

That the Fund continues to develop efficiencies for the benefit of its members, employer bodies and the taxpayer, while mitigating any risks associated with the necessary arrangements, and seeks to continue to improve its service provision and adapt the operation of the division to the wider structural changes facing public sector pension funds.

## Financial impact

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There is no direct financial impact associated with the update of our Compliance Procedures. The cost of the review of investment operational was contained within the 2013/14 finances. Costs associated with authorisation by the FCA (estimated £50K per annum) have been included in the provisional budget for 2014-17 covered elsewhere on the Committee's agenda.

## Equalities impact

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None.

## Sustainability impact

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None.

## Consultation and engagement

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

## Background reading / external references

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None.

## Links

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### Coalition pledges

**Council outcomes** CO26 – The Council engages with stakeholders and works in partnerships to improve services and deliver agreed objectives.

### Single Outcome Agreement

**Appendices** None