

Pensions Committee

2.00pm, Wednesday, 27 March 2019

LPF Group Budget 2019/20 (and indicative 2020/21)

Item number	5.9
Executive/routine	
Wards	All
Council Commitments	Delivering a Council that works for all

1. Recommendations

The Pensions Committee (**Committee**) is requested to:

- 1.1 **approve** the Lothian Pension Fund group (**LPF Group**) budget for 2019-20;
- 1.2 **note** the indicative LPF Group budget for 2020-21;
- 1.3 **note** the continuation of the £10m contingency to address any future requirement for externalisation of the investment management service;
- 1.4 **note** the legal opinion in respect of the flexibility applicable to the LPF budget;
- 1.5 **refer** this report to the boards of LPFE Limited (**LPFE**) and LPFI Limited (**LPFI**) in relation to their respective budgetary obligations; and
- 1.6 **note** that, following approval of the LPF Group budget and consideration by the boards LPFE and LPFI, the updated investment collaboration business case will be reported to the next meeting of the Committee as a private agenda item.

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Report

LPF Group Budget 2019/20 (and indicative 2020/21)

2. Executive Summary

- 2.1 The purpose of this report is to propose the budget for the LPF Group for the year 2019/20 and an indicative budget for 2020/21.

3. Background

- 3.1. Committee is required to approve an annual budget for the LPF Group in order that the statutory obligations of the City of Edinburgh Council (**Council**), as administering authority of the Lothian Pension Fund and the Scottish Homes Pension Fund, can be fulfilled.

4. Main report

LPF Group Budget 2019/20

- 4.1 The proposed budget 2019/20 and indicative budget 2020/21 are included in Appendix 1. The main points to note are summarised below in the Financial Impact section.

LPF Budget – legal differentiation

- 4.2 LPF has a budget which is approved by the Committee each year (a committee of the Council, acting as administering authority). This budget is intended to cover all of LPF's operational costs including pension administration, investment management, employment, property and support costs, and third parties' fees. These represent the administrative costs of running the fund.
- 4.3 It is established in law that local authorities have a duty to balance their budgets, with expenditure that knowingly exceeds budgetary provision not generally being permissible. However, in the case of the Lothian Pension Fund (**LPF**), it is considered that such budgetary constraints, if they are interpreted narrowly, might conflict with other LPF priorities e.g. asset growth, diversification strategy or other longer-term funding considerations.

- 4.4 The potential for such conflict has arisen because there are increased direct costs flowing through the LPF Group owing to changes in LPF's activities over recent years, notably a significant increase in the amount of in-house investment (as opposed to awarding mandates to external fund managers) and the extension of its collaborative services. Historically, these increased direct costs have not resulted in budget issues because they have been balanced by underspends in investment management fees. However, this cushion is diminishing, due to changes in budgetary assumptions and other factors, and is likely to diminish further in future years.
- 4.5 LPF's desired approach would be to present an accurate budget to Committee each year, but with flexibility to note any under or overspending in subsequent updates, rather than having to include significant contingency sums. This would allow LPF and its companies (LPFI and LPFE) to adapt and react to changing business circumstances over the budget period and also to be flexible in providing collaborative services. It would also involve greater accountability and transparency.
- 4.6 Accordingly, LPF sought specialist external legal opinion to clarify matters. In particular, the intention being to confirm whether LPF must, at all times, adhere strictly to budgets as approved by the Committee, or whether there may be an argument for taking a more pragmatic, flexible stance.
- 4.7 The advice confirmed that:

LPF is not a separate legal entity from the Council (albeit LPFI and LPFE are separate companies, with some of LPF's operations being delegated to them). However, in our view the Council, acting as administering authority for LPF, must have regard to wider considerations than it would when acting as a local authority in the usual sense (i.e. providing local authority services paid for by tax revenues).

The fiduciary duty towards scheme employers, equating to a duty to act in their best financial interest, therefore weighed heavily. Furthermore, the ability of the LPF to fund its activities outside of any capital or revenue allocation from the Council, together with internal governance arrangements and the application of financial and pensions regulations separate from those of the Council, were also recognised.

- 4.8 The legal advice concluded that:

LPF's statutory status brings special considerations into play, meaning it would be appropriate, and that there is statutory support, to adopt a more flexible approach to the budgetary process than that which would normally be appropriate for the Council when it is acting in its capacity as a local authority (as opposed to an administering authority for Local Government Pension Scheme in Scotland (LGPSS)).

5. Next Steps

- 5.1 The immediate next steps are reflected in the report recommendations.

- 5.2. Monitoring updates detailing actual and projected expenditures by comparison to the approved budget will be reported to each Committee.

6. Financial impact

- 6.1 The proposed budget for invoiced costs represents a £3,541k increase to the comparable 2018/19 budget. The key changes comprise the following:

	Increase/ (Decrease) £'000
<u>Employee Costs</u> – Additional posts have been added, including three additional investment professionals. An increase in employer pension and National Insurance contributions has also been reflected, as well as revised accounting treatment (following advice) for variable and vested pay.	975
<u>Supplies & Services</u> – Increased expenditure for property management systems and additional licence requirements for the investment front office trading system have been offset, to a limited extent, by savings from the new pensions administration software contract. Provision has also been made for enhanced cost benchmarking and various human resource services.	194
<u>Investment Management-Uninvoiced</u> : Increase in management and performance fees reflects the continued deal flow in both infrastructure and private debt assets to meet the funds' long term strategic allocation and the positive performance of those assets.	2,600
<u>Support Costs</u> – The major cost increase reflects the need for significantly enhanced ICT service provision. The cost estimate will be further refined during the procurement process with specialist input, but does attempt to recognise all requisite hardware and software upgrades, together with consultancy and project management support. Service level agreement charges in respect of other direct service provision by the City of Edinburgh Council are also reflected, with recognition of mailing savings arising from the new supply of secure off-site printing.	357
<u>Income</u> – Revenue from the investment management cost-sharing arrangements with collaborative partners is expected to increase, together with other smaller-scale recoveries.	(605)

- 6.2 Please note that external investment manager fees (invoiced) has not changed from 2018/19. Following the merger of Lothian Buses Pension Fund to the main fund, the bespoke investment strategy of that employer will be reviewed shortly. Although it expected that efficiency savings will accrue, these have not been reflected in a specific budgetary reduction, pending completion of the review.
- 6.3 Continuing its practice of recent years, the fund has not included within its budget for uninvoiced investment management costs, investment performance fees which are driven by changes in market values. The significance of this is expected to diminish over time as historic private equity investments approach the realisation stage of their lifecycle.

- 6.4 An additional £30k capital provision has been included in anticipation of potential injection of regulatory capital to LPFI Limited to meet Financial Conduct Authority (FCA) requirements. A detailed regulatory capital and risk assessment will be undertaken, with support from BDO (formerly Moore Stephens), in support of LPFI's application for investment management authorisation, and so this provision is a very general approximation at this stage in the process. A further update will be provided to Committee when appropriate.
- 6.5 The proposed budget continues to include £10 million contingency to be utilised in the specific event of significant departures from the internal investment team compelling the outsourcing of funds to external managers.

7. Stakeholder/Community Impact

- 7.1 The Pension Board, comprising employer and member representatives, is integral to the governance of the funds and they are invited to comment on the relevant matters at Committee meetings.
- 7.2 There are no adverse health and safety, governance, compliance or regulatory implications as a result of this report.
- 7.3 There are no adverse sustainability impacts arising from this report. Background reading/external references.

8. Background reading/external references

- 8.1 None.

9. Appendices

- 9.1 Appendix 1 – LPF Group Budget 2019/20 (and indicative 2020/21).

LPF Group Budget

The budget for 2019-2020 and indicative for 2020-2021 are as follows:

	Budget 2018/19 £000	Movement £000	Proposed Budget 2019/20 £000	Indicative Movement £000	Indicative Budget 2020/21 £000
Employees	4,379	975	5,354	526	5,880
Plant and Transport	250	5	255	15	270
Supplies and Services	1,934	194	2,128	28	2,156
Third Party Payments	1,439	-	1,439	-	1,439
Investment Managers Fees - Invoiced	5,200	-	5,200	-	5,200
– Uninvoiced*	17,100	2,600	19,700	1,000	20,700
Support Costs	286	357	643	-	643
Capital Funding	132	15	147	-	147
Gross Expenditure	30,720	4,146	34,866	1,569	36,435
Income - Stock Lending	(550)	-	(550)	-	(550)
- Collaboration	(740)	(535)	(1,275)	(60)	(1,335)
- Other	(20)	(70)	(90)	-	(90)
Total Income	(1,310)	(605)	(1,915)	(60)	(1,975)
Net Expenditure	29,410	3,541	32,951	1,509	34,460

*Note budgeted figures do not include performance fees

Investment Managers Fee Contingency	10,000	-	10,000	-	10,000
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Capital Expenditure

LPFI Share Capital	90	30	120	(120)	-
Total Capital Expenditure	90	30	120	(120)	-

LPF Group Budget

The budget for 2019-2020 is comprised thus:

	2019/20 Proposed Budget LPF £000	2019/20 Proposed Budget LPFE Ltd £000	2019/20 Proposed Budget LPFI Ltd £000	2019/20 Proposed Budget LPF Group £000
Employees	29	5,312	13	5,354
Plant and Transport	238	17	-	255
Supplies and Services	1,846	130	152	2,128
Third Party Payments	1,439	-	-	1,439
Investment Managers Fees - Invoiced	5,200	-	-	5,200
- Uninvoiced	19,700	-	-	19,700
Support Costs	643	-	-	643
Capital Funding	147	-	-	147
Gross Expenditure	29,242	5,459	165	34,866
Income - Stock Lending	(550)	-	-	(550)
- Collaboration	-	-	(1,275)	(1,275)
- Other	(90)	-	-	(90)
Total Income	(640)	-	(1,275)	(1,915)
Intra-group transfers	4,552	(5,602)	1,050	-
Net Expenditure	33,154	(143)	(60)	32,951