

# Notice of meeting and agenda

## **Pensions Audit Sub-Committee**

**2:00pm, Tuesday 11 December 2018**

Dunedin Room, City Chambers, High Street, Edinburgh

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

### **Contact:**

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## **1. Order of business**

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

## **2. Declaration of interests**

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

## **3. Deputations**

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- 3.1 If any

## **4. Minute**

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- 4.1 Minute of the Pensions Audit Sub-Committee of 25 September 2018 (circulated) - submitted for approval as a correct record

## **5. Reports**

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- 5.1 Agenda Planning – report by the Executive Director of Resources (circulated)
- 5.2 EU Tax Claims and Other Income Tax Recoveries - report by the Executive Director of Resources (circulated)
- 5.3 Investment Income Review Cross Border Withholding Tax – report by the Executive Director of Resources (circulated)
- 5.4 Global Custody Services Performance – report by the Executive Director of Resources (circulated)

## **6. Motions**

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- 6.1 If any

### **Laurence Rockey**

Head of Strategy and Communications

### **Committee Members**

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Councillors Rose (Convener) and Child; John Anzani.

## Information about the Pensions Audit Sub-Committee

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The Pensions Audit Sub-Committee consists of 3 members of the Pensions Committee of which a minimum of two are City of Edinburgh Councillors and its membership is appointed by the Pensions Committee.

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

### Further information

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If you have any questions about the agenda or meeting arrangements, please contact Lesley Birrell, Committee Services, City of Edinburgh Council, Business Centre 2:1, Waverley Court, 4 East Market Street, Edinburgh EH8 8BG, Tel 0131 529 4240 email [lesley.birrell@edinburgh.gov.uk](mailto:lesley.birrell@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/meetings](http://www.edinburgh.gov.uk/meetings) .

For remaining item of business likely to be considered in private see separate agenda.

## **Pensions Audit Sub-Committee of the Pensions Committee**

**2.00pm, Tuesday 25 September 2018**

**Present**

**Sub-Committee members:**

Councillors Rose (Convener) and Child; John Anzani

**Pensions Board members:**

Alan Williamson

**Independent Professional Observer:**

Andy McKinnell

### **1. Minutes**

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#### **Decision**

To approve the minutes of the Pensions Audit Sub-Committee of the Pensions Committee of 26 June 2018 as a correct record.

### **2. Agenda Planning**

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An overview of potential reports for future Pensions Committee and Pensions Audit Sub-Committee meetings in December 2018 and March 2019 were outlined.

#### **Decision**

To note the agenda planning document.

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

### **3. Audited Annual Report 2018 of the Lothian Pension Fund, Lothian Buses Pension Fund and Scottish Homes Pension Fund, including Annual Report by External Auditor**

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The Audited Annual Report for the year ended 31 March 2018 for the Lothian Pension Fund, the Lothian Buses Pension Fund and the Scottish Homes Pension Fund was provided. The unaudited Annual Report had been considered by the external auditor Scott-Moncrieff and their annual report to Members and the Controller of Audit was presented.

Representatives from Scott-Moncrieff were present for this item.

#### **Decision**

- 1) To note the report by Scott-Moncrieff “Lothian Pension Funds 2017/18 Annual Audit Report to Members and the Controller of Audit” as detailed in Appendix 1 to the report by the Executive Director of Resources.

- 2) To note the audited Annual Report for the year ended 31 March 2018 for the Lothian Pension Fund, the Lothian Buses Pension Fund and the Scottish Homes Pension Fund as detailed in Appendix 2 to the report by the Executive Director of Resources.
- 3) To note that the audited financial statements, for the year ended 31 March 2018, of both the wholly-owned companies, LPFE Limited and LPFI Limited, were approved by the respective Board of Directors in May 2018 as detailed in Appendix 3 and Appendix 4 to the report by the Executive Director of Resources.

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

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

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

##### **Decision**

To note the business update on the operations of LPFE Limited and LPFI Limited.

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

#### **5. Pensions Administration Data Quality**

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Information was given of the ongoing work to enhance the quality of pension administration membership record data.

##### **Decision**

To note and be assured by the report by the Executive Director of Resources.

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

#### **6. Irrecoverable Overpayment of Pensions – Decisions Made under Delegated Authority**

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Delegated authority had been granted to the Executive Director of Resources to write-off pension overpayments up to £3,000, in certain circumstances. Details were given of pension overpayments that had been deemed irrecoverable during the period 1 September 2017 to 31 August 2018.

##### **Decision**

To note that the total value of pension overpayments written off between 1 September 2017 and 31 August 2018 was £1,860.33.

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

#### **7. Fraud Prevention**

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Information was provided of the work undertaken by the Lothian Pension Fund to prevent fraud. Details were given of participation in fraud prevention initiatives as part of the control environment and the overall management of risk.

## **Decision**

To note the report by the Executive Director of Resources.

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

## **8. Risk Management Summary**

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A summary was provided of the Lothian Pension Fund's risk management procedures, including details on the operational risk register and the Fund's action to mitigate these risks.

## **Decision**

To note the Quarterly Risk Overview.

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

## **9. ICT Update**

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The Sub-Committee agreed under Section 50(A)(4) of the Local Government (Scotland) Act 1973, to exclude the public from the meeting for the following items of business on the grounds that they would involve the disclosure of exempt information as defined in Paragraphs 8 and 11 of Part 1 of Schedule 7A of the Act.

An update was provided on work being undertaken to improve ICT platform systems and service provision.

## **Decision**

To note the report.

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

# Pensions Audit Sub Committee

2.00pm, Tuesday, 11 December 2018

## Agenda Planning

<b>Item number</b>	5.1
<b>Report number</b>	
<b>Executive/routine</b>	
<b>Wards</b>	All
<b>Council Commitments</b>	<a href="#">Delivering a Council that works for all</a>

### Executive Summary

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

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

## Agenda Planning

### 1. Recommendations

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Committee is requested to:

- 1.1 Note the Audit Sub Committee meeting to be held in March 2019.
- 1.2 Note the agenda planning document; and
- 1.3 Note that the Pension Board are invited to comment on agenda items during Committee meetings.

### 2. Background

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- 2.1 In order for the Committee and Pension Board to gain an overview of the content of future meetings, it was agreed that an agenda planning document be submitted each quarter.
- 2.2 Pension Committee meetings are held on a quarterly basis and the Audit Sub Committee meetings are held three times a year.
- 2.3 At its meeting on Monday 26 March 2018 the Pensions Committee noted that the Pensions Audit Sub-Committee would '*continue to meet three times in the year in June, September and December but that additional meetings would be arranged if business required.*'

### 3. Main report

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- 3.1 Based on the Committee cycle and the current position, the proposed agendas for the next two meetings are set out below. It includes an additional Audit Sub Committee meeting to be held in March as agreed with the Convenor of the Audit Sub Committee, Councillor Cameron Rose due to the postponement of papers in December 2018.

#### March 2019

Pensions Committee	Audit Sub Committee
<ul style="list-style-type: none"><li>• Audit plans and reports (internal and external)</li><li>• Policies and Strategies Update (including Member Charging Policy/Schedule of Charges and the</li></ul>	<ul style="list-style-type: none"><li>• Audit plans and reports (internal and external)</li><li>• Internal Audit Reports</li><li>• Cost Benchmarking</li><li>• Investment Controls and Compliance.</li></ul>



revised Pensions Administration Strategy) <ul style="list-style-type: none"> <li>• Governance Update</li> <li>• Employers Participating in Lothian Pension Fund</li> <li>• Service Plan Update and Budget for 2019/20</li> <li>• Risk management summary</li> </ul>	
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## June 2019

<b>Pensions Committee</b> <ul style="list-style-type: none"> <li>• Referrals / recommendations from Pensions Audit-Sub Committee</li> <li>• LPF Annual Report &amp; Accounts Unaudited</li> <li>• Statement of Investment Principles</li> <li>• Investment Strategy Panel Activity</li> <li>• Annual Investment Updates – Lothian Pension Fund, Lothian Buses Pension Fund and Scottish Homes Pension Fund</li> <li>• Risk management summary</li> </ul>	<b>Audit Sub Committee</b> <ul style="list-style-type: none"> <li>• LPF Annual Report &amp; Accounts Unaudited</li> <li>• Risk Management Summary</li> </ul>
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## Future Pensions Committee and Audit Sub Committee dates:

<b>Pensions Committee</b> <ul style="list-style-type: none"> <li>• Wednesday, 27 March 2019, 2pm, Dunedin Room, City Chambers</li> <li>• Wednesday, 26 June 2019, 2pm, Dunedin Room, City Chambers</li> </ul>	<b>Pensions Audit Sub Committee</b> <ul style="list-style-type: none"> <li>• Tuesday, 26 March 2019, 10am, Dunedin Room, City Chambers</li> <li>• Tuesday, 25 June 2019, 2pm, Dunedin Room, City Chambers</li> </ul>
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## 4. Measures of success

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

## 5. Financial impact

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- 5.1 None.

## **6. Risk, policy, compliance and governance impact**

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- 6.1 There is no direct impact as a result of this report. The forward planning of the Committees' agendas should facilitate improved risk management and governance for the pension funds.

## **7. Equalities impact**

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- 7.1 There are no equalities implications as a result of this report.

## **8. Sustainability impact**

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

## 9. Consultation and engagement

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- 9.1 The Pension Board, comprising employer and member representatives, is integral to the governance of the Fund and they are invited to comment on the relevant matters at Committee meetings.

## 10. Background reading/external references

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- 10.1 None

### **Stephen S. Moir**

Executive Director of Resources

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## 11. Appendices

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Appendix 1 – Scheme of Committee Papers

Frequency	Pensions Committee	Audit Sub Committee	Month
Annually	Audit plans and reports (internal and external)	N/A - Draft audits and plan will be developed in consultation with the Convenor of the Audit Sub Committee.	March
	Policies and Strategies Update (including revised Pension Administration Strategy biennial from March 2016)	N/A	March
	Service Plan (every 2 years)	N/A	March
	Budget	N/A	March
	Governance Update (including Pension Audit Sub-Committee appointments)	N/A	March
	LPF Annual Report & Accounts Unaudited	LPF Annual Report & Accounts Unaudited	June
	Statement of Investment Principles	N/A	June
	Investment Strategy Panel Activity	N/A	June
	Annual Investment Updates - Lothian Pension Fund, Lothian Buses Pension Fund and Scottish Homes Pension Fund	N/A	June
	LPFE limited and LPFI limited Annual Report	LPFE limited and LPFI limited Annual Report	September
	Annual Report & Accounts Audited of the Lothian Pension Fund, Lothian Buses Pension Fund and Scottish Homes Pension Fund, including the Annual Report by External Auditor.	Annual Report & Accounts Audited of the Lothian Pension Fund, Lothian Buses Pension Fund and Scottish Homes Pension Fund, including the Annual Report by External Auditor.	September
	N/A	Pensions Data Quality	September
	N/A	Irrecoverable overpayment of pensions – decisions made under delegated authority	September
	N/A	Fraud Prevention	September
Annual Report by External Auditor	Annual Report by External Auditor	December (or September if available)	
Benchmarking	N/A	December	
N/A	EU Tax Claims and Other Income Tax Recoveries	December	
N/A	Investment Income Review-Cross-Border Withholding Tax	December	
Stewardship and Engagement	N/A	December	
N/A	Investment Controls & Compliance	December	
N/A	Global Custody Services Performance	December	
	Risk Management In-depth review	December	

Frequency	Pensions Committee	Audit Sub Committee	Month
Semi Annually	Employers Participating in Lothian Pension Fund	N/A	March & September
3 Times per year	Service Plan Update	N/A	March, September & December
	Referrals / recommendations from Pensions Audit-Sub	N/A	June, September & December
Quarterly	Risk management summary	Risk management summary	March, June, September and December
Every 3 years	Actuarial Valuation: LPF/LBPF/SHPF Funding Strategy Statement		December or March
As required	Delegated authorities (provider appointments) Discretions (death grants etc.) N/A Regulatory Update Investment Strategy Reviews (at least every 3 years) N/A	N/A N/A Internal Audit Reports N/A N/A Risk management (in depth review)	

# Pensions Audit Sub Committee

2.00pm, Tuesday, 11 December 2018

## EU Tax Claims and Other Income Tax Recoveries

Item number	5.2
Report number	
Executive/routine	
Wards	All
Council Commitments	<a href="#">Delivering a Council that works for all</a>

### Executive Summary

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This report summarises activity on EU and other special tax claims made on behalf of Lothian Pension Fund. During the period since the last report, no additional claims have been paid and the amount recovered to date remains at £1.3million. Progress on outstanding claims is discussed in detail within the report. The main developments are:

- Legal success on the Manninen and Manufactured Overseas Dividend claims;
- Appointment of a new provider to make additional tax recovery claims on a no win no fee basis;
- Appointment of Deloitte to recover withholding tax on Taiwanese dividends.

## EU Tax Claims and Other Income Tax Recoveries

### 1. Recommendations

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Committee is requested to:

- 1.1 Note the report and highlight any points it would like to raise at the Pensions Committee on 12 December 2018.

### 2. Background

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- 2.1 EU tax claims relate to the recovery of tax deducted from dividend payments prior to receipt or payable tax credits thereon. They relate to a fundamental principle of EU law, that all member states should not discriminate in the application of national taxes between home tax payers and those in other member states in a way that is likely to hinder the free movement of capital. The claims can be divided into three main types – Manninen / Foreign Income Dividends (FIDs), Manufactured Overseas Dividends (MODs) and Fokus.
- 2.2 Progress on a claim to recover tax on Taiwanese dividends is also covered in this report.

### 3. Main report

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

- 3.1 These claims are against the UK tax authorities. The FIDs claim is based on the UK providing for the repayment of tax credits on UK dividends but not on Foreign Income Dividends ("FIDs") paid by UK companies.
- 3.2 The European Court of Justice's ruling in the Manninen tax case in September 2004 opened an avenue for claims for tax credits on EU dividends. Pensions Committee has previously agreed to pursue potential claims.
- 3.3 Based on the decision in the Manninen case, KPMG's EU Tax Group is undertaking statutory claims on behalf of UK pension funds to claim a repayment of tax credits on FIDs and overseas dividend income in respect of periods 1990/91 to 1997/98. Pension funds have also pursued parallel claims in the High Court.
- 3.4 The claims are for tax credits and are based on the rate of advance corporation tax in place in respect of the overseas dividends. While the UK tax authorities are disputing the validity of such claims, the estimates show that Lothian Pension Fund could benefit by up to £2.6m from a successful claim. A cost benefit analysis concluded that a claim should be lodged, and this was done on 9 February 2006.

- 3.5 HMRC has rejected all claims of this nature. As a result, KPMG has appointed a firm of solicitors (Pinsent Masons) to pursue recovery by way of a test case brought with the BT Pension Scheme as the test claimant.
- 3.6 A chronology of events to date is provided in Appendix 1. The contents of which have been approved by Pinsent Mason.
- 3.7 The positive news is that as a result of the Court of Appeal's determination of the statutory claims in December 2017, the Court also made award of costs to the test claimant of £287k. As Lothian Pension Fund contributed to the legal cost of the case, it is entitled to a share of the award. We await news of the amount.
- 3.8 Fees incurred to date, by Lothian Pension Fund, on these claims amount to £63.4k (£63.4k as at the last update to Committee in December 2017). Assuming that the case is pursued to a final conclusion, total costs for the Fund are capped at £90k. This compares with the claim for £2.6m.

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

- 3.9 This claim is against the UK tax authorities. It is based on the fact that manufactured dividend receipts relating to UK shares were not subject to any UK withholding tax but receipts relating to manufactured overseas dividends suffered a UK withholding tax.
- 3.10 Note that manufactured dividends are dividends created when a security is out on loan at the time the company pays a dividend.
- 3.11 Claims in respect of manufactured dividends totalling £4,870.6k have been lodged with HMRC on behalf of Lothian Pension Fund.
- 3.12 KPMG has appointed a firm of solicitors (Pinsent Masons) to pursue recovery.
- 3.13 A chronology of events to date is provided in Appendix 2. The contents of which have been approved by Pinsent Mason. The positive news is that in May 2018 the Upper Tribunal (Tax and Chancery) decided in favour of the test claimant and against referring the judgement to the Court of Justice of the European Union.
- 3.14 Fees incurred to date on these claims amount to £175.7k (£162.3k as at the meeting of December 2017). Potential subsequent referrals are estimated to cost £20k for each legal stage.

### **Claims – Fokus Bank**

- 3.15 These claims are against the tax authorities of the EU member states (and Norway) in which the Fund has invested. The basis of the claims is that the tax authorities have applied favourable tax treatment to domestic pension funds that they have denied to pension funds in other member states.
- 3.16 The Pensions Committee of October 2007 approved making claims under the principle established in the Fokus Bank case. Claims currently estimated at around £4.57m have been made. Progress on the claims is summarised in Appendix 3.



- 3.17 Fees incurred to date on these claims amount to £390.5k (£389.7k as at the meeting of December 2017). Costs are higher for the Fokus Bank type claims because of the need to file claims separately in individual EU countries.

### Claims – Taiwan

- 3.18 Last year's report on cross border withholding tax identified the opportunity to make additional claims to recover tax deducted on dividends from Taiwanese companies. It was reported to the Pensions Audit Sub Committee that a procurement activity would be carried out to appoint a firm of accountants to make the relevant claims.
- 3.19 After reviewing a number of quotations, Deloitte has been appointed to make claims for three calendar years (2016, 2017 and 2018). The potential amount to be recovered is in excess of £700k.

## 4. Measures of success

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

## 5. Financial impact

- 5.1 Tax claims totalling of £12.8m have now been lodged with the relevant tax authorities. Professional fees amounting to £629.6k have been paid to date. As previously agreed by Pensions Committee, it is likely that further legal costs will be incurred in pursuing the claims. However, any legal costs are shared across a pool of fellow claimants and Lothian Pension Fund has the right to cease participation without incurring further costs.
- 5.2 Currently, claims paid to date exceed the costs incurred by £740.5k. So irrespective of the outcome of the remaining claims Lothian Pension will accrued a financial benefit. The financial position can be summarised as follows:

<b>Claim Type</b>	<b>Total Claims £'000</b>	<b>Claims Settled £'000</b>	<b>Claims Outstanding £'000</b>	<b>Costs to Date £'000</b>
Manninen	2,626.7	Nil	2,626.7	63.4
Manufactured Dividends	4,870.6	Nil	4,870.6	175.7
Fokus Bank	4,574.5	1,370.1	3,204.4	390.5
Taiwan	700.0	Nil	700.0	Nil
	<b>12,771.8</b>	<b>1,370.1</b>	<b>11,401.7</b>	<b>629.6</b>

## 6. Risk, policy, compliance and governance impact

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

## 7. Equalities impact

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- 7.1 There are no equalities implications as a result of this report.

## 8. Sustainability impact

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

## 9. Consultation and engagement

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- 9.1 The Pension Board, comprising employer and member representatives, is integral to the governance of the Fund and they are invited to comment on the relevant matters at Committee meetings.

## 10. Background reading/external references

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- 10.1 None

### **Stephen S. Moir**

Executive Director of Resources

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## 11. Appendices

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Appendix 1 **Chronology - Manninen / Foreign Income Dividends (FIDs)**

Appendix 2 **Chronology - Manufactured Overseas Dividends (MODs)**

Appendix 3 **Fokus Bank – Claims Summary**

### Chronology - Manninen / Foreign Income Dividends (FIDs)

Date	Event
March 2011	First-tier Tribunal (FTT) published its judgement on the test case: <ul style="list-style-type: none"> <li>• Withholding of tax credits on foreign income dividends and overseas dividends (Manninen) was a breach of EU law – the substantive issues.</li> <li>• All but one of the claims were out of time because they were made more than six years after the end of the tax year in which the relevant dividends were received - the out of time issue.</li> </ul>
July 2012	Appeal against the FTT judgement was heard by the Upper Tribunal.
February 2013	Upper Tribunal published its judgement on the appeal and supports judgement of the FTT.
April 2013	Upper Tribunal refuses HMRC's request for leave to appeal on the substantive issue and claimants' request on the out of time issue.
June 2013	Court of Appeal approves direct requests to appeal from HMRC and claimants.
November 2013	Court of Appeal advises that a preliminary hearing will be held in December 2013 to decide if any questions related to the case should be referred to the Court of Justice of the European Union (CJEU).
January 2014	Court of Appeal rejects the claimants' appeal on the out of time issue (based on UK domestic law). A further hearing by the Court of Appeal was set for February 2015 to consider HMRC's appeal on the substantive issue and the out of time issue (based on European law). It is possible that the Court of Appeal will refer certain issues to the CJEU at this hearing.
June 2015	The second Court of Appeal hearing took place in June 2015 concerning EU law based "out of time" arguments and the substantive issues.
July 2015	The Court of Appeal handed down its judgement: <ol style="list-style-type: none"> <li>1. The original decision on the out of time issue is upheld.</li> </ol>

Date	Event
	<p>2. On the substantive FIDs issue the Court has decided to refer this to the CJEU.</p> <p>3. The Court did not determine the substantive Manninen issue because it was found not to be relevant as the claims were out of time.</p> <p>On the FIDs substantive issue the parties agreed the specific questions that will be referred to the CJEU.</p>
August 2015	On the out of time issue an application for permission to appeal was submitted to the Supreme Court directly.
January 2016	<p>The Supreme Court refuses to grant permission to appeal on out of time issue.</p> <p>CJEU acknowledge start of legal process on the substantive issue. Hearing should take place late in 2016 with the judgement likely to be issued within six months afterwards.</p>
November 2016	CJEU hearing was held on 9 November 2016.
December 2016	The Opinion of the Advocate General was released, which recommended that the CJEU should conclude that the denial of payable tax credits on FIDs was an unjustifiable breach of EU law.
September 2017	CJEU full judgement released on 14 September 2017. This is a positive outcome with a clear finding of a breach of EU law in denying tax credits on FIDS.
December 2017	After delivery of the CJEU judgment the Court of Appeal made an order to determine the statutory claims reflecting the fact that the test claimant succeeded with the FIDs claim for the year 1997/98. However, the remainder of the test claimant's statutory claims were held to be out of time by the Court of Appeal and as such no recovery can be made for those periods at present via the statutory claims.
June 2018	<p>Following the determination of the statutory appeals, the stay on the High Court proceedings was lifted.</p> <p>However, claimants should maintain their statutory claims as these may assist the High Court claims as the stay on these claims has now been lifted.</p> <p>As regards the High Court claims, a restitutionary Counsel has been appointed.</p>

Date	Event
September 2018	<p>A suitable timetable has been agreed with HMRC for exchanging updated pleadings and next steps.</p> <p>The test claimant's amended pleadings were served on HMRC on 31st August and then lodged at court on 7th September.</p>
October 2018	<p>Based on the current timetable, HMRC are likely to file their amended defences by 26 October 2018. The deadline for BTPS (the test claimant) to serve a reply, if this is considered necessary, is 17 December 2018.</p> <p>Once both parties have served their amended or fully pleaded statements of case, we expect the Court to list a case management conference in due course. The case management conference is therefore likely to take place in the early part of 2019. The full substantive hearing before the High Court should therefore be in the latter part of 2019.</p>

### Chronology - Manufactured Overseas Dividends (MODs)

Date	Event
March 2013	An initial hearing of the First-tier Tribunal (FTT) took place.
During 2014	Pinsent Masons were in correspondence with HMRC through the course of 2014 and have agreed a statement of facts in order to minimise the fact-finding undertaken by the Tax Tribunal at the hearing itself.
November 2015	The case was heard by the FTT (sitting in London between 2 and 5 November 2015). A decision was reserved by the Tribunal to be handed down at a later date.
July 2016	The FTT concluded that there was a movement of capital, but that the MODs rules applied by HMRC did not amount to a restriction on the movement of capital.
August 2016	The FTT granted the test claimant permission to appeal its decision to the Upper Tribunal.
October 2016	The Upper Tribunal (UT) stage commenced.
March 2017	UT rejected immediate reference to CJEU. Reference was requested as it was deemed beneficial to make the reference as early as possible in view of the UK's scheduled exit from the European Union.
July 2017	Substantive UT appeal has been listed for a hearing in February 2018.
May 2018	During May the UT issued a decision in favour of the test claimant and did not consider it necessary to refer its judgement to the Court of Justice of the European Union (CJEU).
June 2018	HMRC applied to the UT to appeal the decision. The UT granted HMRC's application for permission to appeal to the Court of Appeal.
July 2018	HMRC lodged their appeal at the Court of Appeal and commenced proceedings before the Court of Appeal.

<b>Date</b>	<b>Event</b>
October 2018	To date, the parties have exchanged skeleton arguments and the Court of Appeal has recently listed the substantive hearing for 25 – 27 June 2019.

### Fokus Bank – Claims Summary

Country	Claim Period From / To	Estimated Amount Claimed	Amount Received	Notes
<b>Completed Claims</b>				
Austria	2006 2010	£83.0k	£83.0k	Claim paid in September 2012.
Netherlands	2003 2006	£440.0k	£440.0k	Claim paid in 2009.
Norway	2004 2010	£278.9k	£278.9k	All claims paid - final instalment received in February 2013 (£73k)
Spain	2004 2009	£568.2k	£568.2k	All claims paid - final instalment received in March 2015 (£102k)
<b>Active Claims</b>				
France	2005 2009	£675.7 [€776.7k]	-	<p>15% tax imposed on all pension funds from 1 January 2009 – so no further claims can be made after that date. In May 2012, the EU Court ruled in the Santander test case that refunds must be paid to investment funds.</p> <p>In February 2016 KPMG submitted a comparability analysis demonstrating that Lothian Pension Fund is in a similar situation to the test claimant. For efficiency purposes our claim is being included in a batch with similar claimants. This has delayed the filing of the documentation with the French Tax Authorities (FTA).</p> <p>To date KPMG have not received any response from the FTA. KPMG will contact the FTA in 2018 if they do not start to hear from them in respect of any clients and consider whether any other action should be taken. The FTA's willingness to resolve the cases is highly influenced by political influence in France.</p>



Country	Claim Period From / To	Estimated Amount Claimed	Amount Received	Notes
				<p>Significant interest accrues on any refunds from France and it is paid automatically.</p> <p>There have been no developments since the last report.</p>
Germany	<p>KPMG 2003 2010</p> <p>Deloitte 2011 2014</p> <p>WTax 2015 2017</p>	<p>£936.1k [€1,076.0k]</p> <p>£117.9k [€135.5k]</p> <p>£996.8 [€1,145.8k]</p>	-	<p>In August 2015, following a competitive tender, Deloitte LLP was appointed to make additional claims in respect of the calendar years 2011 to 2014 inclusive.</p> <p>After appropriate due diligence, WTax was appointed in 2018, on a no win no fee basis, to recover any withholding tax not normally recovered by the custodian. WTax has decided to make additional claims in Germany</p> <p>To date, the German Tax Authorities (GTA) have ignored the claims filed by UK-resident pension schemes to date and litigation is likely to be required in this territory. Litigation has been pursued by a Canadian resident pension fund in Germany. The Fiscal Court of Munich issued a decision in October 2017, confirming that it considered the Canadian pension fund to be comparable to a pension fund under German law and that the Court did not see any reason why discrimination could be justified.</p> <p>The Court, at the same time, referred questions to the Court of Justice of the European Union (CJEU). Firstly, the Court queried whether the levying of withholding tax at 26.375% on dividend distributions to the pension fund is an infringement of Article 63 (Free Movement of Capital) of the Treaty on the Functioning of the European Union (TFEU) when a German pension fund is taxed on a net basis, with deductions allowable for technical reserves in respect of future pension liabilities.</p>

Country	Claim Period From / To	Estimated Amount Claimed	Amount Received	Notes
				WTax is currently participating in friendly litigation with Germany using one of their clients as a test case and are hopeful that the results will be positive.
Italy	2007 2010	£181.5k [€208.6k]	-	<p>The Italian Tax Authority (ITA) has taken no action in respect of claims and it seems litigation will be required for a resolution. There has been little appetite amongst claimants to date, to fund a test case. KPMG believe claimants prefer to concentrate efforts on France and Germany before considering Italy.</p> <p>Under Italian law, claims must be renewed after a period of 10 years. In 2017, Officers considered the cost of refreshing the claim and the potential for the claims being paid and decided not to pursue this option. This means that €391.9k of the original claims have lapsed, reducing the value of the remaining claim to the £181.5k stated above.</p> <p>WTax, which operates on a no win no fee basis, has decided not to pursue claims in Italy.</p>
Denmark	2016 2017	£65.4k [€75.1k]		After appropriate due diligence, WTax was appointed in 2018, on a no win no fee basis, to recover any withholding tax not normally recovered by the custodian. WTax has decided to make some claims in Denmark.

<b>Country</b>	<b>Claim Period From / To</b>	<b>Estimated Amount Claimed</b>	<b>Amount Received</b>	<b>Notes</b>
				Previous providers did not consider it economic to make claims in this country.
Sweden	2013 2017	£231.0k [€265.6k]		After appropriate due diligence, WTax was appointed in 2018, on a no win no fee basis, to recover any withholding tax not normally recovered by the custodian. WTax has decided to make some claims in Sweden.  Previous providers did not consider it economic to make claims in this country.
<b>TOTAL</b>		<b>£4,574.5k</b>	<b>£1,370.1k</b>	

# Pensions Audit Sub Committee

2.00pm, Tuesday, 11 December 2018

## Investment Income Review Cross Border Withholding Tax

Item number	5.3
Report number	
Executive/routine	
Wards	All
Council Commitments	<a href="#">Delivering a Council that works for all</a>

### Executive Summary

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This report provides information on a benchmarking study prepared by Deloitte into the effectiveness of the procedures in place to manage the tax exposure on the investment income of Lothian Pension Fund, Lothian Buses Pension Fund and Scottish Homes Pension Fund.

The benchmarking report prepared by Deloitte shows that Northern Trust is generally applying the correct withholding tax rates on investment income. Recovery claims are being processed and reclaims received but Deloitte advise that the time taken seems to be longer than the market standard for refunds (particularly for Switzerland and Germany). A summary of the opportunities and issues identified is provided.

## Investment Income Review Cross Border Withholding Tax

### 1. Recommendations

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Committee is requested to:

- 1.1 Note the report and highlight any points it would like to raise at the Pensions Committee on 12 December 2018.

### 2. Background

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#### The Taxation Environment

- 2.1 Lothian Pension Fund (LPF), Lothian Buses Pension Fund (LBPF) and Scottish Homes Pension Fund (SHPF) invest directly in stock markets across the globe. These investments generate income that is potentially liable to income tax in the country of tax domicile. During the 2017/18 financial year the Pension Funds earned income from companies in 32 different countries.
- 2.2 UK pension funds are usually able to benefit from beneficial tax rates. These rates are normally determined by separate tax treaties established between the UK Government and most foreign countries. Tax on dividends varies between 0% and 35%. In contrast, income on fixed interest stocks is usually free from tax.
- 2.3 In virtually all countries income is subject to taxation at source, so the owner of the investments receives the income net of the appropriate amount of tax. Taxation deducted in this way is called withholding tax or WHT for short.
- 2.4 In some countries, the preferential rate for UK pension funds is subject to providing the tax authorities of the country concerned with an application and supporting paperwork. The exact requirements vary from country to country and in some cases, can be quite onerous. Failure to have preferential rate approval in place means that income will be subject to a higher rate of tax than is necessary.
- 2.5 The preferential rate may be applied at source, meaning that there is no tax to reclaim from the foreign tax authority. Alternatively, the rules of the country may require tax to be deducted at the full rate with a subsequent claim having to be made to the tax authority to get repayment of the difference between the full rate and the preferential rate.
- 2.6 The requirements to make a valid repayment claim and the time it takes for the claim to be paid vary considerably from country to country.

## The Role of the Custodian

- 2.7 The custodian appointed for the three pension funds is Northern Trust (NT). In addition to the vital role of holding title to investments on behalf of the investor, the global investment custodian is responsible for the management of the procedures and processes that relate to the taxation of investment income.

## The Scale of Activity

- 2.8 The tables below show the movement in the reclaimable tax balances during the 2017/18 and 2016/17 financial years for LPF, LBPF and SHPF.

<b>Lothian Pension Fund</b>	<b>2017/18</b> £	<b>2016/17</b> £
Brought Forward 1 April	4,202,688.28	3,998,673.01
Recoverable tax accrued during year	4,013,549.79	3,975,760.09
Claims paid during year	(1,081,720.51)	(3,771,744.82)
Carried Forward 31 March	7,134,517.56	4,202,688.28

<b>Lothian Buses Pension Fund</b>	<b>2017/18</b> £	<b>2016/17</b> £
Brought Forward 1 April	407,275.08	433,978.69
Recoverable tax accrued during year	244,662.28	326,214.98
Claims paid during year	(126,709.75)	(352,918.59)
Carried Forward 31 March	525,227.61	407,275.08

<b>Scottish Homes Pension Fund</b>	<b>2017/18</b> £	<b>2016/17</b> £
Brought Forward 1 April	-	-
Recoverable tax accrued during year	46,229.12	-
Claims paid during year	(1,406.28)	-
Carried Forward 31 March	44,822.84	-

- 2.9 The balance carried forward increased by £2,932k for LPF, increased by £118k for LBPF and 2017/18 was the first year for SHPF.
- 2.10 The year-end recoverable tax balances at 31 March 2018 and 31 March 2017, broken-down by country, are provided for each of the Funds in the tables below.

<b>Lothian Pension Fund</b>	<b>Reclaim Amount 31/3/18 £</b>	<b>Number of Dividends 31/3/18</b>	<b>Reclaim Amount 31/3/17 £</b>	<b>Number of Dividends 31/3/17</b>
Austria	55,867.68	18	54,505.28	18
Denmark	60,061.61	15	28,431.85	9
France	152,254.73	14	64,130.39	47
Germany	1,648,577.42	34	723,567.24	16
Netherlands	273,002.25	19	175,751.82	20
Norway	296,524.33	10	443,846.94	24
Spain	2048.54	1	18,513.24	4
Sweden	-	-	340.54	1
Switzerland	4,455,400.72	50	2,583,419.00	28
United Kingdom*	190,780.28	8	110,181.98	4
<b>Grand Total</b>	<b>7,134,517.56</b>	<b>169</b>	<b>4,202,688.28</b>	<b>171</b>

<b>Lothian Buses Pension Fund</b>	<b>Reclaim Amount 31/3/18 £</b>	<b>Number of Dividends 31/3/18</b>	<b>Reclaim Amount 31/3/17 £</b>	<b>Number of Dividends 31/3/17</b>
Denmark	10,130.12	6	6,607.61	4
France	1,931.31	2	36,396.33	11
Germany	172,932.27	13	91,675.58	7
Netherlands	18,836.98	5	13,414.91	5
Norway	46,745.97	12	60,039.98	15
South Africa	-	-	1,118.65	1
Spain	-	-	2,584.93	1
Switzerland	257,558.27	11	178,232.03	7
United Kingdom*	17,092.69	4	17,205.06	4
<b>Grand Total</b>	<b>525,227.61</b>	<b>53</b>	<b>407,275.08</b>	<b>55</b>

<b>Scottish Homes Pension Fund</b>	<b>Reclaim Amount 31/3/18 £</b>	<b>Number of Dividends 31/3/18</b>	<b>Reclaim Amount 31/3/17 £</b>	<b>Number of Dividends 31/3/17</b>
Canada	3,702.48	8	-	-
France	9,580.77	3	-	-
Germany	12,124.28	4	-	-
Japan	1,380.31	1	-	-
Netherlands	2,361.45	4	-	-
Norway	4,634.87	6	-	-
Switzerland	8,401.98	2	-	-
United Kingdom*	2,636.70	4	-	-
<b>Grand Total</b>	<b>44,822.84</b>	<b>32</b>	<b>-</b>	<b>-</b>

\* Relates to Royal Dutch Shell dividends.

- 2.11 SHPF was mainly invested in pooled funds, so there was no requirement to recover income tax as this was organised by the pooled fund manager. However, with a change in investment strategy, the Scottish Homes Pension Fund had direct holdings in equity investments during the period March 2017 to March 2018. An Index Linked Gilts strategy was adopted in March 2018. As a result, SHPF had some outstanding withholding tax claims at 31 March 2018.
- 2.12 For LPF, Switzerland accounts for 62% (61% at 31 March 2017) for the total amount receivable, for LBPF 49% (44% at 31 March 2017), and for the Scottish Homes Pension Fund 19%. The reason why the Swiss total claim value is so large is that 35% tax is deducted on all dividends and the 0% rate relief is obtained by claiming the tax paid back. There are few other countries where the tax deducted at source is so high.
- 2.13 The Swiss, German, Dutch, Norwegian and French claims are analysed in more detail later in this report.

### 3. Main report

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#### **Benchmarking Study**

- 3.1 Given the complexity and scale of the taxation of investment income, it is important that the Funds' custodian, Northern Trust (NT), provides an efficient service. Failure to ensure that the correct tax rates are being applied would result in a direct loss of income. Poor management of the tax reclaim process could mean that recoverable tax is never recovered or delayed.
- 3.2 In order to assess the effectiveness of NT's work, Deloitte has been commissioned to prepare a benchmarking report. The remit was to carry out a review of the WHT suffered for the period 1 August 2017 to 31 July 2018. Deloitte have also been asked to review the timeliness of the WHT reclaims made by the custodian in respect of this period.

#### **Findings – WHT Rates Applied**

- 3.3 The study concluded that: "In general, optimal WHT rates appear to have been achieved by the Fund for the majority of dividend distributions received, subject to a few exceptions." However, they have identified a number of potential opportunities and issues. These are summarised in the Appendix to this report. NT has been asked to respond to the points raised and these responses have been included in the Appendix.

#### **Findings – WHT Claims**

- 3.4 The reclaim process consists of the custodian preparing an application in the required format for the country concerned. Once the application has been lodged with the tax authorities of the country, it will take the authority an amount of time to



process the claim and pay the refund. This processing time varies from country to country – some take a matter of months and others will take a number of years.

3.5 The Deloitte report identified examples of NT’s claims processing being slower than the market standard for such work. However, with the exception of the Swiss, German, Dutch and Norwegian claims the amounts involved were relatively low. The responses of NT to various matters identified have been summarised below. We will continue to work with NT to ensure that our claims are processed as quickly as possible.

3.6 Swiss claims accounted for 62% (£4,455k) of the value of Lothian Pension Fund claims. The amounts due can be summarised as follows:

Year	Lothian Pension Fund	Lothian Pension Fund	Lothian Pension Fund	Comment
	31/10/18 £	31/3/18 £	31/3/17 £	
2016	-	1,519k	1,630k	Paid in 2018/19
2017	2,132k	2,040k	953k	NT status at 31 October 2018: “Documentation Required”. This refers to a NT specific documentation status. There is no requirement for action from LPF.
2018	2,037k	896k	-	Claim cannot be made until the end of the calendar year.
<b>Total</b>	<b>4,169k</b>	<b>4,455k</b>	<b>2,583k</b>	

3.7 The reason for the increase in the balance for the Swiss claims is the 2016 claim not being paid until the 2018/19 financial year. The factors accounting for the delay have been queried with NT.

3.8 NT has stated that the 2016 reclaims were submitted in 2017 and received in 2018 which is within the expected reclaims cycle. Overall in Q1 2017 the Swiss tax authorities have implemented a new payment system which has resulted in delays to the overall processing timeframes from that point.

3.9 For Germany, the position for the LPF claims can be summarised as follows:

Year	Lothian Pension Fund	Lothian Pension Fund	Lothian Pension Fund	Comment
	31/10/18 £	31/3/18 £	31/3/17 £	
2016	643k	636k	621k	NT status at 31 October 2018: “Market Issue”
2017	903k	893k	103k	NT status at 31 October 2018: “Market Issue”

Year	Lothian Pension Fund	Lothian Pension Fund	Lothian Pension Fund	Comment
2018	1,073k	120k	-	NT status at 31 October 2018: "Market Issue"
<b>Total</b>	<b>2,619k</b>	<b>1,649k</b>	<b>724k</b>	

3.10 The reason for the increase in the balance for the German claims is the 2016 claim not being paid to date. NT has stated that in 2018 a post submission enquiry was received from the German Tax Authority requesting transaction information. This can be sourced internally by NT. Such requests were prevalent within the market around 5 years ago but we now have seen them arise on an ad-hoc basis. In addition, in 2017 German domestic tax law introduced an investment holding period of 45 days before and after ex-dividend date which has impacted UK pension funds. As a result, NT have been implementing enhancements to their system to appropriately capture and accrue the reclaims. This is expected to be completed in Q4 2018. This is why the reclaims were assigned a "Market Issue" status.

3.11 For the Netherlands, the position for the LPF claims can be summarised as follows:

Year	Lothian Pension Fund	Lothian Pension Fund	Lothian Pension Fund	Comment
	<b>31/10/18</b>	<b>31/3/18</b>	<b>31/3/17</b>	
		£	£	
2013		-	5k	Paid 2017/18
2016		-	143k	Paid 2017/18
2017	33k	241k	28k	Paid 2018/19
2018	86k	32k	-	Too early to claim
<b>Total</b>	<b>119k</b>	<b>273k</b>	<b>176k</b>	

3.12 The reason for the increase in the balance for the Netherlands claims is the increase in withholding tax for 2017 compared to previous years. The claims are being paid in-line with previous experience.

3.13 For Norway, the position for the LPF claims can be summarised as follows:

Year	Lothian Pension Fund	Lothian Pension Fund	Lothian Pension Fund	Comment
	<b>31/10/18</b>	<b>31/3/18</b>	<b>31/3/17</b>	
	£	£	£	
2015		-	223k	Paid 2017/18
2016	91k	89k	221k	Part payment in 2017/18
2017	195k	190k	-	NT status at 31 October 2018: "Claim Submitted"
2018	102k	18k	-	Too early to claim

Year	Lothian Pension Fund	Lothian Pension Fund	Lothian Pension Fund	Comment
<b>Total</b>	<b>388k</b>	<b>297k</b>	<b>444k</b>	

3.14 The reason for the decrease in the balance for Norwegian claims is a reduction in the amount of withholding tax experienced compared to the previous year.

3.15 For France, the position for the LPF claims can be summarised as follows:

Year	Lothian Pension Fund	Lothian Pension Fund	Lothian Pension Fund	Comment
	31/10/18 £	31/3/18 £	31/3/17 £	
2015		-	33k	Paid 2017/18
2016	-	-	30k	Paid 2017/18
2017	1k	151k	1k	Paid 2018/19
2018	2k	1k	-	Too early to claim
<b>Total</b>	<b>3k</b>	<b>152k</b>	<b>64k</b>	

3.16 The reason for the increase in the balance for the French claims is an increase in the amount of withholding tax experienced. The claim was paid by 31 October 2018.

## 4. Measures of success

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

## 5. Financial impact

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- 5.1 The financial impact of the withhold tax claims is described in section 2.8 of this report.

## 6. Risk, policy, compliance and governance impact

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- 6.1 There is the potential risk of failure to recover the correct amount of withholding tax. The objective of the annual benchmarking report is to minimise this risk.
- 6.2 There are no policy, compliance and governance impacts arising from this report.

## 7. Equalities impact

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- 7.1 There are no equalities implications as a result of this report.

## **8. Sustainability impact**

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

## **9. Consultation and engagement**

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9.1 The Pension Board, comprising employer and member representatives, is integral to the governance of the Fund and they are invited to comment on the relevant matters at Committee meetings.

## **10. Background reading/external references**

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10.1 None

### **Stephen S. Moir**

Executive Director of Resources

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## **11. Appendices**

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Appendix 1 – Summary of the findings of the withholding tax benchmarking report

11 December 2018

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

Country	Findings	Conclusions as at Date of Preparation of Report to Pensions Audit Sub-Committee
Germany	<p>Summary: Approximately £707,785 may be reclaimable through EU law reclaims. Deloitte can provide support in this regard if needed. We would note this may be a long process, as Germany are not currently processing claims.</p>	<p><b>LPF Conclusion:</b> As discussed in the separate report to the Pensions Audit Sub Committee on EU Tax Claims and Other Income Tax Recoveries:</p> <p>WTax was appointed in 2018, on a no win no fee basis, to recover any withholding tax not normally recovered by the custodian. WTax has decided to make additional claims in Germany. Claims covering the calendar years 2015, 2016 and 2017, totalling £997k have been made.</p>
Israel	<p>Summary: Approximately £110,961 may be reclaimable through double tax treaty relief. In the first instance, we would recommend discussing this point with NT to determine if they are able to reclaim this amount through their standard procedures. The completion of some tax documentation may be necessary. Deloitte would be happy to assist if needed.</p>	<p><b>LPF comment:</b> NT has been contacted on this point and we await their comments.</p> <p><b>NT response:</b> In 2018 there was a change in the statute of limitations in Israel which allowed NT to retrospectively reclaim past withholding tax.</p> <p><b>LPF Conclusion:</b> The matter seems to be resolved. However, we have asked for confirmation.</p>
South Korea	<p>Summary: 22% WHT has been incurred on all dividends. There may be an opportunity for double tax treaty reclaims c. £3,214.94. This should be queried with your custodian in the first instance.</p>	<p><b>LPF comment:</b> NT has been contacted on this point and we await their comments.</p> <p><b>NT response:</b> There was a lapse in relief at source documentation due to the name difference (City of Edinburgh). This has since been resolved and documentation is in place for the reduced rates.</p> <p><b>LPF Conclusion:</b> The matter is resolved.</p>

Country	Findings	Conclusions as at Date of Preparation of Report to Pensions Audit Sub-Committee
Taiwan	<p>Summary:  Approximately £296,152 is reclaimable through double tax treaty relief. Deloitte has already been engaged to provide support in this regard.</p>	<p><b>LPF comment:</b>  A claim was submitted to reclaim the WHT suffered in excess of the UK-Taiwan Double Tax Treaty in August 2010 for the years 2005 to 2009 for £469k. A top up claim was submitted in 2013 for £192k. These claims have now been paid. Therefore, it should be possible to make claims from 2013 onwards.</p> <p><b>LPF Conclusion:</b>  As discussed in the separate report to the Pensions Audit Sub Committee on EU Tax Claims and Other Income Tax Recoveries:</p> <p>After reviewing a number of quotations, Deloitte has been appointed to make claims for three calendar years (2016, 2017 and 2018). The potential amount to be recovered is in excess of £700k.</p>

# Pensions Audit Sub Committee

2.00pm, Tuesday, 11 December 2018

## Global Custody Services Performance

Item number	5.4
Report number	
Executive/routine	
Wards	All
Council Commitments	<a href="#">Delivering a Council that works for all</a>

### Executive Summary

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This report presents the Key Performance Indicator Report for the 12 months ended 30 September 2018 provided by the Funds' custodian, Northern Trust. The purpose of this report is to demonstrate that the performance of the custodian is regularly monitored to ensure that the services provided meet the needs of the three Pension Funds.

The report highlights that the indicator for Corporate Actions elected within deadline has remained Red for the year. As per previous years, a majority of late responses related to an external investment manager (83% of late responses). From investigation, the Fund has comfort that these responses have not been late and the issue relates to how "default" corporate actions are being picked up between the manager and Northern Trusts system.

During the period, there was an improvement in the timeliness of receipt for the monthly asset valuation and financial reporting of the Fund. Previously delays were caused in the production of final valuation reports due to queries raised by the Fund.

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

## Global Custody Services Performance

### 1. Recommendations

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Committee is requested to:

- 1.1 Note the report and highlight any points it would like to raise at the Pensions Committee on 12 December 2018.

### 2. Background

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- 2.1 Following a competitive tender process, Northern Trust has provided investment custody services since early in 2011 for the three Pension Funds. Provision of these services is vital to the management of the Funds' investments. The range of services includes:
  - Safe custody of investment assets.
  - Reconciling investment valuations and accounts.
  - Ensuring that investment transactions are processed within market requirements.
  - Collecting investment income.
  - Providing notification of all corporate actions and passing responses to the companies concerned.
- 2.2 In order to assess the services provided a number of key performance indicators have been agreed with Northern Trust. These indicators are subject of a report from Northern Trust, the latest of which is for the 12 months ended 30 September 2018. The indicators cover the services listed above.
- 2.3 In addition, Northern Trust provides foreign exchange conversion and investment income tax services. The performance of these services is assessed in separate annual reports, with the former being considered by the Investment Strategy Panel. The only other significant service provided is securities lending, this revenue item being included in the budget and outturn figures which are also presented to Committee.
- 2.4 In February 2014's external consultancy review of the Funds' investment arrangements it was recommended that the Fund should conduct regular operational reviews of key outsourced providers and incorporate onsite visits with face to face meetings. Following this review the Fund has undertaken an annual site visit to Northern Trusts' offices in London for the past three years.



### 3. Main report

3.1 Information about all of the performance indicators is summarised below:

#### Month End Valuation Reporting

Description of Indicator	Month end valuation reports of investments completed and reviewed by Northern Trust and available to client within the target number of business days of end of the previous month.
Performance Traffic Lights	Green – Completed by business day 14 Amber – Completed by business day 15 Red – Completed by business day 16 or later
Service Rating Over 12 Months to 30/9/18	Green (Previous Report: Amber)
Comments	<p>Unreviewed valuations are available on business day one; these are accurate for quoted investments. Portfolios that contain unquoted investments take longer for valuation information to be obtained.</p> <p>Month end valuations provided by Northern Trust are reconciled with records maintained by the external or internal investment manager. In addition, checks are made on the prices used by Northern Trust and the prices used by the external or internal investment manager.</p> <p>On one occasion during the year, our accounts were signed off after the 14-day target (March 2018). The delay in sign off was as a result of queries submitted by the Funds' staff over asset valuations. Queries are regularly raised to improve the accuracy of the monthly valuations and are an essential part of quality assurance role played by the Funds' staff. Working proactively with Northern Trust helps to minimise future problems.</p>

#### Financial Reporting

Description of Indicator	Since April 2012, Northern Trust has been responsible for providing investment accounts for all three Pension Funds. This includes a month end trial balance and summary accounts and at the year end additional information for inclusion in the annual accounts.
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	Month end investment accounting packs should be completed and sent to the Fund within the target number of business days of end of the previous month.
Performance Traffic Lights	Green – Completed by business day 18 Amber – Completed by business day 19 Red – Completed by business day 20 or later
Service Rating Over 12 Months to 30/9/18	Green (Previous Report: Amber)
Comments	More time is allowed at the year end for the preparation of the additional information required for the annual accounts.  The month end accounts are checked by the Fund for accuracy. Any delays in month end valuation reporting have a knock-on effect in completion of the monthly financial reporting.

#### Trade Settlement Statistics

Description of Indicator	Each investment market around the world has a set of requirements that must be followed regarding the settlement of trades (purchases and sales). These requirements include a fixed number of business days for a trade to be settled. For example, shares trade in the UK must be settled in a three-day period. Within that period each side must “deliver” either the shares or the cash as appropriate.  The indicator is the percentage of trades that have settled on time.
Performance Traffic Lights	Green – 94% or higher Amber – 92% to 94% Red – lower than 92%
Service Rating Over 12 Months to 30/9/18	Green (Previous Report: Green 97.06%) 95.58%
Comments	During the period, there were a total of 5,065 trades of which 4,841 (95.58%) were settled on time. Of the 224 trades settled late, 197 were purchases and 27 were sales. This is due to a common market issue where the selling

	<p>broker does not initially have sufficient shares to settle the purchase trade.</p> <p>Northern Trust provides a range of reports on settlement statistics; this includes one that provides information by broker. This is particularly useful for identifying the source of settlement problems.</p> <p>Northern Trust provides contractual settlement on all trades. For sales, Northern Trust will credit the Fund with the cash proceeds on the contractual settlement date of the underlying trade regardless of whether it settles on time in the market. Northern Trust would then seek compensation by issuing a market claim against the purchasing broker.</p>
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### Income Collection Statistics

Description of Indicator	<p>It is the responsibility of the custodian to account for all dividend income when it becomes due and to receive the money into the bank when the dividend is actually paid.</p> <p>The indicator is the percentage of the number of income payments received on pay day.</p>
Performance Traffic Lights	<p>Green – 95% to 100%</p> <p>Amber – 90% to 95%</p> <p>Red – lower than 90%</p>
Service Rating Over 12 Months to 30/9/18	<p>Green (Previous Report: Green 98.34%)</p> <p>98.50%</p>
Comments	<p>The performance indicator is based on the number of income collections rather than their value. During the period, there were a total of 2,397 income collections, 2,361 (98.50%) of which were received on the correct pay day.</p> <p>Northern Trust provides a range of reports on income receipts including one that provides information by country. This report is useful to identify any problems at the market, rather than individual company, level.</p> <p>Northern Trust provides contractual income in around 46 countries. This means that Northern Trust endeavours to credit the Fund's bank account with the income on its pay date irrespective of the actual date of receipt.</p>

## Corporate Actions

<p>Description of Indicator</p>	<p>Corporate actions are events announced by companies that give shareholders the opportunity to make a decision on two or more potential choices. For example:</p> <ul style="list-style-type: none"> <li>• Rights issue to buy additional shares</li> <li>• Dividend reinvestment in additional shares</li> <li>• Receive dividend in GBP, USD or EUR</li> </ul> <p>It is the responsibility of the custodian to collate responses from its clients to corporate actions and communicate the results to the company. The Fund has the responsibility of responding to corporate actions on a timely basis.</p> <p>The indicator is the percentage of responses made by the client with the deadline date set by the company for a response.</p> <p>The Fund has the responsibility of responding to corporate actions on a timely basis. Responses are made by external and internal investment managers for the portfolios that they are responsible for.</p>
<p>Performance Traffic Lights</p>	<p>Green – 100%</p> <p>Amber – 95% to 99%</p> <p>Red – lower than 95%</p>
<p>Service Rating Over 12 Months to 30/9/18</p>	<p>Red</p> <p>93.52 % (Previous Report: Red 94.86%)</p>
<p>Comments</p>	<p>During the period, there were 463 corporate actions, 433 (93.52%) of which are recorded as having been responded to within the time limit.</p> <p>Northern Trust provide an online system to advise clients of all upcoming corporate actions. The same system is used by the client to record decisions. As the deadline for an action approaches and no response has yet been recorded, Northern Trust staff will attempt to contact the client for a response. Contact is initially made by e-mail and on the day prior to the deadline contact by phone is attempted. If a client response cannot be obtained Northern Trust will elect the default option for the action.</p> <p>Of the 30 late items 25 related to one of the Fund’s external managers. After investigation, it was discovered that the issue relates to how certain default corporate actions are</p>

	<p>being captured between the manager and Northern Trust systems rather than late action.</p> <p>On assessment, the late corporate actions did not represent the potential for financial loss to the Fund.</p>
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- 3.2 On 11<sup>th</sup> October 2018 the Fund conducted its annual site visit to Northern Trust's London office. Areas covered included –

LGPS Asset Pooling	Discussion on the current developments in England and Wales following the creation of asset pools and the implications for Northern Trust.
Accounting/Valuation Reporting	Overview of the arrangements in place to ensure accuracy /consistency in the valuation basis of the Funds assets. Discussions on ongoing changes to CIPFA guidance and pressed on improvements to their own reporting with regards to the Cost Transparency Code, with reference to current FX and Money Market arrangements in place for the Fund.
Alternatives/Private Equity Monitoring	Review of arrangements in place to administer Funds' unlisted assets. Covered areas such as controls, staff and training arrangements. Exploring the possibility of having a direct customer liaison within the team.
Securities Lending	Overview of Lothian's current securities lending program and review of the controls/restrictions in place for program.
Cybersecurity	Provided with an overview of the Information Security Structure in place at Northern Trust, the types of threats faced and controls in place.
Business Continuity	An update and overview of the business continuity arrangements in place within Northern Trust.

#### 4. Measures of success

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

#### 5. Financial impact

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- 5.1 The budget set for the provision of custody services for 2018/19 is £427k. This report has no impact on the cost of custody provision.
- 5.2 Poor performance of the custodian could have a financial impact on the three Pension Funds. For example: from delays in, or failure to, collect investment

income or failure in the system to notify companies of decisions made in response to corporate actions. However, staff monitor service provision and corrective action are taken if any issues arise.

- 5.3 The cost and quality of custody services are assessed as part of a rigorous competitive procurement exercise. Northern Trust was the winner of the last exercise and the initial contract was set for five years ending in February 2017, with the Fund choosing to take up its option to extend for a further three years to February 2020. Northern Trust has a strong presence in the LGPS market and has retained a high credit rating (AA-) for many years and has not been involved in high profile litigation cases with clients (in contrast to some other global custodians).

## **6. Risk, policy, compliance and governance impact**

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

## **7. Equalities impact**

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- 7.1 There are no equalities implications as a result of this report.

## **8. Sustainability impact**

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

## **9. Consultation and engagement**

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- 9.1 The Pension Board, comprising employer and member representatives, is integral to the governance of the Fund and they are invited to comment on the relevant matters at Committee meetings.

## **10. Background reading/external references**

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- 10.1 None.

### **Stephen S. Moir**

Executive Director of Resources

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**11. Appendices**

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None