Pension Fund Committee AGENDA

DATE: **Tuesday 25 June 2013**

TIME: **6.30 pm**

VENUE: **Committee Room 6, Harrow Civic Centre**

MEMBERSHIP (Quorum 3)

Chairman: Councillor Richard Romain

Councillors:

Tony Ferrari
Keith Ferry
Sachin Shah

(Non-voting Co-optee): Mr H Bluston

Trade Union Observer(s): Mr S Compton - UNISON
Mr S Karia - GMB

Reserve Members:

1. Stephen Wright
2. Kam Chana

1. Bill Phillips
2. Bill Stephenson

Contact: Una Sullivan, Democratic & Electoral Services Officer
Tel: 020 8424 1785 E-mail: una.sullivan@harrow.gov.uk

Harrow COUNCIL LONDON

AGENDA - PART I

1. ATTENDANCE BY RESERVE MEMBERS

To note the attendance at this meeting of any duly appointed Reserve Members.

Reserve Members may attend meetings:-

(i) to take the place of an ordinary Member for whom they are a reserve;
(ii) where the ordinary Member will be absent for the whole of the meeting; and
(iii) the meeting notes at the start of the meeting at the item 'Reserves' that the Reserve Member is or will be attending as a reserve;
(iv) if a Reserve Member whose intention to attend has been noted arrives after the commencement of the meeting, then that Reserve Member can only act as a Member from the start of the next item of business on the agenda after his/her arrival.

2. DECLARATIONS OF INTEREST

To receive declarations of disclosable pecuniary or non pecuniary interests, arising from business to be transacted at this meeting, from:

(a) all Members of the Panel;
(b) all other Members present.

3. APPOINTMENT OF VICE-CHAIRMAN

To appoint a Vice-Chairman of the Pension Fund Committee for the Municipal Year 2013-14.

4. MINUTES (Pages 1 - 8)

That the minutes of the Pension Fund Investment Panel meeting held on 6 March 2013 be taken as read and signed as a correct record.

5. PUBLIC QUESTIONS

To receive questions (if any) from local residents/organisations under the provisions of Committee Procedure Rule 17 (Part 4B of the Constitution).

6. PETITIONS

To receive petitions (if any) submitted by members of the public/Councillors under the provisions of Committee Procedure Rule 15 (Part 4B of the Constitution).

7. DEPUTATIONS

To receive deputations (if any) under the provisions of Committee Procedure Rule 16 (Part 4B) of the Constitution.

8. PENSION IMPLICATION OF SERVICE OUTSOURCING (Pages 9 - 14)

Report of the Director of Finance and Assurance

9. INFORMATION REPORT - PRESENTATION BY WM (Pages 15 - 16)

Report of the Director of Finance and Assurance

10. REVIEW OF THE STATEMENT OF INVESTMENT PRINCIPLES (Pages 17 - 30)

Report of the Director of Finance and Assurance

11. EQUITY TRAINING AND BELIEFS (Pages 31 - 74)

Report of the Director of Finance and Assurance

12. INFRASTRUCTURE AND LOCAL INVESTING (Pages 75 - 90)

Report of the Director of Finance and Assurance

13. EXTERNAL AUDIT PLAN 2012-13 (Pages 91 - 118)

Report of the Director of Finance and Assurance

14. INFORMATION REPORT - UPDATE REPORT AND ACTION POINTS FROM PREVIOUS MEETINGS (Pages 119 - 126)

Report of the Director of Finance and Assurance

15. LONDON PENSION FUND COLLABORATION (Pages 127 - 142)

Report of the Director of Finance and Assurance

16. ANY OTHER URGENT BUSINESS

Which cannot otherwise be dealt with.

AGENDA - PART II

17. INFORMATION REPORT - INVESTMENT MANAGER MONITORING (Pages 143 - 198)

Report of the Director of Finance and Assurance

18. INFORMATION REPORT - PERFORMANCE OF FUND MANAGERS FOR QUARTER ENDED 31 MARCH 2013 (Pages 199 - 204)

Report of the Director of Finance and Assurance

[Please note that Aon Hewitt, Advisers to the Fund, will be attending this meeting.]

This page is intentionally left blank

PENSION FUND INVESTMENTS PANEL
MINUTES

6 MARCH 2013

Chairman:	* Councillor Keith Ferry	
Councillors:	* Mano Dharmarajah * Tony Ferrari	* Richard Romain
Co-optee (Non-voting):	* Howard Bluston	† Steve Compton Sanjay Karia

Mr Sion Cole, Mr Craig Nowrie and Ms Emily McGuire attended as representatives of Aon Hewitt, the Council's Adviser.

*   Denotes Member present
†   Denotes apologies received

201. Attendance by Reserve Members

RESOLVED: To note that there were no Reserve Members in attendance.

202. Declarations of Interest

RESOLVED: To note that there were no declarations of interests made by Members.

203. Minutes

RESOLVED: That the minutes of the meeting held on 8 January 2013 be taken as read and signed as a correct record.

204. Public Questions, Petitions and Deputations

RESOLVED: To note that no petitions were received, questions put, or deputations received under the provisions of the Committee Procedure Rules 17, 15 and 16.

RESOLVED ITEMS

205. Information Report - Update Report and Action Points from Previous Meetings

The Panel received a report of the Corporate Director of Resources which provided an update on actions taken since the last meeting. An officer added that two of the outstanding items were on the agenda for this meeting. He further advised the Panel that an actuarial review was due, and that the Council's Actuary would present their findings to the Panel at the July meeting.

Members considered if the review would result in a recommendation to increase contributions, and any possible impact on the budget. The Corporate Director of Resources stated that there was provision for this in the Medium Term Financial Strategy, and that if an increase was considered necessary it would be accommodated.

RESOLVED: That the report be noted.

206. Meeting Plan 2013-14

The Panel received the report of the Corporate Director of Resources, which set out the expected routine agenda items for the next 12 months and invited Members' views on any additional matters the Panel wished to add to the programme.

Members discussed the content and frequency of meetings, in the light of both the timelines for statutory reports, and recent proposals to reduce the number of meetings from 5 to 4. An officer added that in addition to the 4 formal meetings, there would be two further informal meetings, at which Panel members could meet with fund managers to assess and discuss their strategy and performance, and also receive briefings on other relevant matters. These informal meetings could be held during the day, and in school holiday periods, and he proposed to arrange the first meeting during the May half term break.

Suggested topics for consideration included:

- new investment opportunities;
- the CIPFA skills framework;
- the revised Pensions Bill, currently going through parliament;
- governance and decision making;
- risks and controls;
- ethical and / or responsible investment.

A Member observed that the existing frequency of meetings had worked well, and provided the flexibility to respond to events – it was easier to cancel a planned meeting than to factor in an extra meeting. The Chairman stated that this was part of a broader strategy to reduce the number of meetings and thereby the reliance on Democratic Services, and that the proposal was to cut the number of formal meetings, but to continue the regular work of the panel through informal briefings and working groups, which would in fact mean an increase in the number from 5 to 6 meetings. He added that if this proved to be impractical, then the frequency could be reviewed and revised in the following municipal year. What was important was the timing of meetings to accommodate statutory reporting cycles, and optimise the receipt of up-to-date information and data.

A Member was happy to support the proposal to reduce the number of meetings, but wanted to ensure that any savings realised through efficiencies relating to the Panel should be retained within the fund.

The Corporate Director of Resources informed the Panel that this was likely to be her last meeting as the interim Section 151 Officer; the new Director of Finance and Assurance would be joining the Council on 25 March and would take over this role.

RESOLVED: That

(1) the report be noted;

(2) an informal meeting to meet the equity fund managers be arranged for the May half term break;

(3) training be provided prior to the commencement of the next meeting on 'good governance' and the CIPFA skills and knowledge framework;

(4) an item on investing in infrastructure be added to the agenda for the next meeting.

207. Any Other Urgent Business

<u>London Pension Fund Merger</u>

In accordance with the Local Government (Access to Information) Act 1985, this item was raised following agenda publication as the information had not been available at the time the agenda was printed and circulated, namely that a working party had recently been formed to take opinions from Councils on this issue, and a response was required before the next meeting of the Panel.

An officer provided a brief summary of outline proposals to consider the desirability and practicality of a pan-London Pension Fund, encompassing all 34 London boroughs. The intention was to rationalise and harness the purchasing and negotiating power of the combined pension funds and achieve economies of scale to deliver lower costs and better returns, and it appeared to be an objective supported by the Mayor of London. Two organisations, the

London Leaders' Committee and the Society of London Treasurers had considered the proposals, and a working party had been formed to consider the Price Waterhouse Coopers report and make recommendations. A similar exercise had been undertaken in Wales, and authorities were invited to make expressions of interest in such a scheme.

The officer pointed out that there were wide variations in practice, performance and workforce profiles among London boroughs in respect of their Pension Funds, and the conclusions that a single entity would deliver savings had to be tested and justified; as yet there was insufficient data to confirm this.

Emily McGuire of Aon Hewitt gave her opinion that it could be possible to achieve many of the objectives through greater collaboration and framework agreements, without the need for a total merger.

Members were unanimous in their view that the Harrow Pension Fund should retain its autonomy, with all activities, investments and decisions being determined by the Pension Fund Panel Members. Members were not averse to consideration of collaboration and framework agreements for specified purposes, and had recently conducted such an exercise with Croydon to procure actuarial advice. Members were not persuaded that the stated objectives would be achieved, or the expected savings delivered. Furthermore, they believed they had a high-functioning and collaborative approach on the Panel which aimed to achieve apolitical consensus in decision making.

The Chairman added that the West London Waste Authority, which numbered 6 local authorities, had been unable to achieve consensus on a project over a number of years. He was sceptical that the Pension Fund merger project was desirable or achievable, and experience suggested that it would create its own bureaucracy, which would negate any benefits or savings.

In conclusion, the Panel expressed its strong and unanimous opposition to any move towards a merger of London Pension Funds, and if such a proposal had support, the Panel would look to join with other, like-minded authorities in resisting any such action.

Legal Action Against the Royal Bank of Scotland

In accordance with the Local Government (Access to Information) Act 1985, this item was raised following agenda publication as the information had not been available at the time the agenda was printed and circulated, namely that the Council had been notified on 14 February 2013 that there was an option to join a group legal action against the Royal Bank of Scotland (RBS). The Legal Department were reviewing this option and had alerted officers that it might require the Panel's approval to incur legal costs.

An officer explained the background to the Council's position; shares in RBS which had been bought prior to the bank's purchase by the government had fallen to a fraction of their purchase value following the bailout. A group legal action had been proposed, to be funded by shareholders similarly affected. Advice from Counsel suggested a 60% chance of success.

Members queried and discussed the following points:

- the likely cost of the action;
- the probability of success;
- the quality of the case for RBS;
- the level of compensation and how this would be apportioned;
- the view and involvement of Harrow's Legal Department.

Members acknowledged that a sophisticated level of expertise would be necessary to assess the likelihood of success in such a complex and technical legal case. They were unable to agree a definite course of action, other than to explore the matter further. They requested more information on those authorities already committed to the group action, and further advice on the probable outcome of any action.

208. Exclusion of the Press and Public

RESOLVED: That in accordance with Part I of Schedule 12A to the Local Government Act 1972, the press and public be excluded from the meeting for the following items for the reason set out below:

Item	Title	Reason
11.	DGF Manager Selection and Strategy Update	Information under paragraph 3 (contains information relating to the financial or business affairs of any particular person (including the authority holding that information).
12.	Information Report - Investment Manager Monitoring	
13.	Information Report – Performance of fund Managers for Quarter Ended 31 December 2012	

209. DGF Manager Selection and Strategy Update

The Panel received the report of the Corporate Director of Resources, which sets out options for investment in Diversified Growth Funds (DGFs), and seeks approval for the revised investment strategy.

An officer outlined the options and proposals contained within the report, and explained the different policies for charging between the two selected fund managers.

Members were generally happy with the selection of the two fund managers, and observed that their strategies complemented one another well, but they disputed the terminology used to describe the asset classes and strategies used by the funds. A Member explained that because membership of the Panel would change over the years, it was important to have accurate and descriptive terminology in order that historical context could be understood. Using the funds' full title in reports would clarify the managers' styles.

Members noted that the initial agreement had been to invest £20m of cash deposits, but they were now being asked to agree to an investment of £80m, with a 50/50 split between the two selected fund managers. A lengthy discussion followed, during which members debated the following:

- the nature and security of the selected funds;
- the total amount to be invested;
- the split of investment between the selected fund managers;
- the source of funds for investment, if a figure larger than £20m were agreed.

The Corporate Director of Resources stated that the recommendations in the report had been prepared by officers following the presentations by fund managers and consideration of all the information available. It was for Members to agree, amend or refuse the recommendations, but the matter had come to the Panel for decision on three occasions, and a decision was necessary.

A Member observed that if the strategy was correct, and offered an acceptable balance between return and risk in an uncertain economic climate, then a higher figure for investment was desirable. Another Member urged caution, citing previous investments which had not delivered the expected returns.

Members agreed to address the points in turn, and having voted on each of them, it was

RESOLVED: That

(1) 10% of the fund be invested in the selected fund managers (5% each to Standard Life and Barings);

(2) the new managers be funded from available cash and the balance to be withdrawn from the Fidelity mandate;

(3) the revised strategy as shown in Appendix 2 of the report be approved subject to reflecting the lower 10% allocation to DGF mandates;

(4) the equity mandates be reviewed at the next meeting;

(5) the alternative fixed income products available from BlackRock be reviewed at a later date;

(6) authority be delegated to the Section 151 Officer (or deputy) to sign any documentation required to complete the appointment of the selected DGF managers.

210. Information Report - Investment Manager Monitoring

The Panel received Aon Hewitt's quarterly report on Harrow's Fund managers, detailing strengths and weaknesses and overall ratings, and noted that the ratings remained unchanged from the January report.

RESOLVED: That the report be noted.

211. Information Report - Performance of Fund Managers for Quarter Ended 31 December 2012

The Panel received a report which set out the performance of the investment managers and of the overall Fund for the quarter, year and three years ending 31 December 2012.

RESOLVED: That the report be noted.

212. Termination of the Meeting

In accordance with the provisions of Committee Procedure Rule 14 (Part 4B of the Constitution) it was

RESOLVED: At 9.55 pm to continue until 10.15 pm.

(Note: The meeting, having commenced at 6.45 am, closed at 10.10 pm).

(Signed) COUNCILLOR KEITH FERRY
Chairman

This page is intentionally left blank

REPORT FOR: Pension Fund Committee

Date of Meeting: 25th June 2013

Subject: Pension Implication of Service Outsourcing

Responsible Officer: Simon George, Director of Finance and Assurance

Exempt: No

Enclosures: None

Section 1 – Summary and Recommendations

Members have requested an opportunity to discuss the pension implication of the proposed libraries outsourcing, for which part of the risks relating to past service liability and assets will be retained by the Council to optimise the overall commercial arrangements.

Recommendation:

The Panel is invited to discuss the proposed pension arrangements and note the intention to review the admission policy to ensure that the financial risk to the Fund and its employers are appropriately identified and managed.

Harrow COUNCIL
LONDON

Section 2 – Report

1. This item has been included at the request of members, who wish an opportunity to discuss the pension implications of the outsourcing of the libraries contract. Gemma Sefton, from Hymans Robertson will be attending the meeting.

2. The norm on a service outsourcing that involves the transfer of Harrow staff is for the new employer to request admitted body status in the scheme. Harrow Council cannot object provided the new employer abides by the regulations and agrees reasonable terms.

3. To date, the standard practice has been that the value of the past service liability for the transferred staff is calculated and allocated to the new employer together with an equal allocation of assets, such that any deficit is retained by the existing employer, e.g. Harrow Council. The Actuary then calculates an initial contribution rate based on the ongoing cost of providing new benefits. The new employer is subject to changes in contribution rates (up or down) at each tri-annual valuation, including due to changes in the value of past service liabilities and assets.

4. It should not be read that transferring matching assets and liabilities will mean future contribution increases. The change in a valuation position will reflect all experience in the inter-valuation period. Changes in the financial assumptions used, salary experience, ill health retirements, mortality experience will all impact on the balance sheet and resulting required employer contributions. For example, if bond yields were to increase from current levels, the value of the liabilities would reduce and all else being equal may result in a contribution reduction.

5. The standard treatment on outsourcing is not mandatory and can be varied by the Council.

6. The ongoing libraries outsourcing involves 109 employees with a past service liability of £6.2 million. The initial standalone contribution rate determined by the Actuary is 25.3% (approximately £0.4 million p.a.), considerably higher than the 19.35% currently paid by the Council, such that the pension fund will receive higher contributions as a result of the out-sourcing, to reflect the calculated cost of new benefit accrual for the transferring members being higher than the stabilised contribution rate currently being paid by the Council.

7. The initial contributions rate payable by the new employer will be reviewed at each valuation in light of:

    a) Changes in the cost of providing future benefits,
    b) Actuarial gains and losses on assets and liabilities acquired post the date of transfer of employment, and
    c) Any action taken by the employer than impacts on pre transfer benefit liabilities e.g. salary increases or ill-health retirements that differ from those assumed.

8. One aspect of the libraries outsourcing that differs from 'standard' practice is that the Council will retain some of the pension risks relating to the historic liabilities and assets as at the date of transfer. In particular, those risks that are not controllable by the new employer e.g. investment performance, discount rates, longevity, changes in inflation etc will remain with the Council. This decision has been made on commercial grounds to encourage a competitive bidding process and eliminate uncertainties that appeared likely to cause pricing adjustments that were excessive in relation to the risks being transferred.

9. The impact of the Council retaining part of the risk relating to the historic liabilities has in this instance not been reflected within the new employer's initial contribution rate. It has been known for an additional contribution charge to be levied in these circumstances, but as additional costs will impact on the contract cost, it has not considered appropriate.

10. At the point of the outsourcing the deficit remains with the Council. A successful outsourcing will reduce the costs of providing the services and as the Council's revenue is unaffected will have a positive financial impact for the Council. Of course if future actuarial outcomes are worse than expected, then a greater burden will fall on the Council due to retaining some of the pension risks, but this is the same position as retaining the staff in-house and forgoing the outsourcing savings.

11. The Committee should note that if significant outsourcings were to occur, the Fund may require additional contributions if contributions continue to be expressed as a percentage of pay. As the deficit is unchanged, that deficit still needs to be repaid, but as it is spread over a reduced payroll it may mean a higher "rate" is required to ensure that the monetary value of deficit contributions is maintained. Therefore, the pensions saving from an outsourcing cannot be assumed to be the rate currently in payment times the outsourced payroll.

12. Risk sharing arrangements such as these usually operate outside of the Fund. This means that at each valuation the Fund continues to calculate the balance sheet of and contribution rate required from, the Employer, regardless of the risk sharing that is in place. It is that certified contribution that the Fund needs to receive from the Employer. Thereafter, there would be an additional calculation to figure out how the contribution rate is split between the Council and the Employer. The Council would then either pay more to the Employer so that it can meet its obligations to the Fund if the required contribution is higher than that priced in the contract or the price of the contract would be reduced if the required contribution is less than that allowed for the original pricing.

13. Comparison has been made with the policy adopted for academies, in which a proportion of the past service deficit was transferred to the academies. This treatment was different because the Council's funding was reduced as part of the move to academy status and the Council has fewer resources to fund the associated deficit. This is not the case with the libraries out-sourcing.

14. The growth in the level of outsourcing and increase in the number of admitted employers has required more time to be devoted to similar pension issues. Some employers are large and sophisticated and understand the pension issues, while others have little understanding and seek simpler solutions to providing pension provision. It is proposed to consider a range of tailored solutions that might be applied to different circumstances while protecting the fund and the Council. These proposals will be discussed with the Committee prior to implementation.

15. One final consideration is that the methodology for recovering deficits may have to change if Harrow's work force continues to shrink, from a percentage of salary to a defined monetary sum. This need not change the value of the deficit contribution but will protect the fund against receiving lower contributions. This is an approach that perhaps should be considered for all Fund employers as part of the 2013 valuation. At a minimum the value of deficit contributions being paid should be monitored.

Financial Implications

16. The impact on the Council from the libraries outsourcing arises both from the commercial aspects of providing services and the impact on the pension fund. The Pension Fund Committee will wish to ensure that the fund is not adversely impacted

Risk Management Implications

17. Risk included on Directorate risk register? No

18. Separate risk register in place? No

19. Setting risk tolerances and measuring outcomes is central to the strategy.

Equalities implications

20. Was an Equality Impact Assessment carried out? Yes

21. There are no direct equalities implications relating to the pension fund.

Corporate Priorities

22. Corporate Priorities are not applicable to the Pension Fund as it does not have a direct impact on Council resources.

Legal Implications

23. The report has been reviewed by Legal Department and comments received are incorporated into the report.

Section 3 - Statutory Officer Clearance

Name: Simon George Date: 11 June 2013	√	Chief Financial Officer
Name: Matthew Adams Date: 11 June 2013	√	Monitoring Officer

Section 4 - Contact Details and Background Papers

Contact: Linda D'Souza (Shared Services Manager) and George Bruce (Treasury and Pension Fund Manager) Tel: 020-8424-1170 / Email: george.bruce@harrow.gov.uk

Background Papers: [None].

If appropriate, does the report include the following considerations?

1.	Consultation	N/A
2.	Corporate Priorities	N/A

This page is intentionally left blank

REPORT FOR: Pension Fund Committee

Date of Meeting: 25th June 2013

Subject: **INFORMATION REPORT – Presentation by WM**

Responsible Officer: Simon George, Director or Finance and Assurance

Exempt: No.

Enclosures: WM Report

Section 1 – Summary

The Committee is requested to receive the presentation and to ask questions relating to the performance of the investment portfolio in the period to 31st March 2013.

FOR INFORMATION

Section 2 – Report

1. Lynn Coventry from WM / State Street will be attending the meeting to provide a presentation to the Panel on the fund's performance over 1, 3 and 5 years comparing returns with the benchmarks set by the Panel and with the returns of other local authority funds. It should be noted that comparisons with other pension funds tend to reflect the strategies adopted by individual schemes more than the success in implementing scheme strategies.

2. A summary of the most up to date returns are given within the performance and valuation agenda item.

Section 3 – Further information

3. N/A

Section 4 - Financial Implications

4. N/A.

Section 5 - Risk Management Implications

5. Risk included on Directorate risk register? No

6. Separate risk register in place? No

Section 6 - Equalities implications

7. Was an Equality Impact Assessment carried out? Yes

8. There are no direct equalities implications relating to the pension fund.

Section 7 - Corporate Priorities

9. Corporate Priorities are not applicable to Pension Fund as it does not have a direct impact on Council's resources.

Name: Simon George Date: 10 June 2013	√	Chief Financial Officer
Name: Matthew Adams Date: 10 June 2013	√	on behalf of the Monitoring Officer

Section 6 - Contact Details / Background Papers

Contact: George Bruce (Treasury and Pension Fund Manager)) Tel: 020-8424-1170 / Email: george.bruce@harrow.gov.uk

Background Papers: None

REPORT FOR: Pension Fund Committee

Date of Meeting:	25th June 2013
Subject:	Review of the Statement of Investment Principles
Responsible Officer:	Simon George, Director of Finance and Assurance
Exempt:	No
Enclosures:	Statement of Investment Principles.

Section 1 – Summary and Recommendations

A revised Statement of Investment Principles ("SIP") is presented here to approval following changes in the Investment Strategy agreed in March 2013.

RECOMMENDATIONS:

The Committee is asked to approve the updated Statement of Investment Principles.

Harrow COUNCIL LONDON

Section 2 – Report

1. A Statement of Investment Principles (“SIP”) is required by the Local Government Pension Scheme (Management and Investment of Funds) (Amendment) Regulations 2009 (“The Regulations”) and outlines the principles and policies followed by the Committee in the management of the Fund’s investments.

2. A revised SIP is necessary following a change in the Investment Strategy at the Pension Fund Committee meeting on 6th March 2013: The changes made have been restricted to those required to reflect the revised strategy and the new Committee title are highlighted below:

- Paragraph 1.3, has been amended to replace ‘Investment Panel’ with ‘Committee’ in four instances.

- Paragraph 3.1 has been amended to include: “Pension Fund Committee meeting on 6th March 2013, at which it was decided to invest 10% of the Fund in two multi-asset mandates amounting to £27 million in each of Barings and Standard Life. This was funded by a reduction in equities together with the use of cash.” In addition the asset allocation table has been updated to reflect the new investments.

- Paragraph 3.4 has been amended to read: “Cash balances are held in Pension Fund bank accounts”

- Paragraph 6.3 has been amended from “80%” to “70%”

- Paragraph 6.5 has been amended to include “The Council monitors liabilities using quarterly funding estimates from the Actuary together with a…”

3. These amendments are incorporated into the attached SIP, which the Committee is invited to approve. The revised SIP will be sent to all fund employers and investment managers and a copy will be available to scheme members via the Council’s web site

4. The SIP complies with relevant regulations and it is recommended that it is reviewed annually to ensure that it continues to reflect the Committees investment strategy.

Financial Implications

5. The SIP addresses the high level risk and return objectives of the Fund.

Risk Management Implications

6. Risk included on Directorate risk register? No

7. Separate risk register in place? No

8. Setting risk tolerances and measuring outcomes are central to the management of contribution volatility.

Equalities implications

9. Was an Equality Impact Assessment carried out? Yes

10. There are no direct equalities implications relating to the pension fund.

Corporate Priorities

11. Corporate Priorities are not applicable to the Pension Fund as it does not have a direct impact on Council's resources.

Section 3 - Statutory Officer Clearance

Name: Simon George Date: 10 June 2013	√	Chief Financial Officer
Name: Matthew Adams Date: 10 June 2013	√	on behalf of the Monitoring Officer

Section 4 - Contact Details and Background Papers

Contact: George Bruce (Treasury and Pension Fund Manager) Tel: 020-8424-1170 / Email: george.bruce@harrow.gov.uk

Background Papers: None

If appropriate, does the report include the following considerations?

1.	Consultation	N/A
2.	Corporate Priorities	N/A

This page is intentionally left blank

LONDON BOROUGH OF HARROW PENSION FUND

STATEMENT OF INVESTMENT PRINCIPLES

LONDON BOROUGH OF HARROW PENSION FUND

STATEMENT OF INVESTMENT PRINCIPLES

CONTENTS

This Statement of Investment Principles has been prepared in consultation with the Fund's investment managers and investment advisor. Fund members and other employing authorities will be given the opportunity to comment on the Statement and the Council will consider their views.

Approved by Harrow Council:

Date June 2013

Introduction

1.1 This is the Statement of Investment Principles (SIP) adopted by Harrow Council (the Council) in relation to the investment of assets of the Council's Pension Fund (the Fund). The Council is the Administering Authority of the Fund and, in that role it has responsibility to ensure the proper management of the Fund.

1.2 This SIP meets the requirements of The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 ("The Regulations") and has been prepared after taking appropriate advice.

1.3 The Council, as administering authority, decides on the investment policies most suitable to meet the liabilities of the Pension Fund and has ultimate responsibility for investment strategy. These powers are exercised on its behalf by the Council's Pension Fund Committee. The Committee monitors investments, including manager performance, on a quarterly basis. Advice is received as required from the officers and the professional advisers. In addition, the Committee requires managers to periodically attend its meeting. The Committee is responsible for monitoring compliance with guidance given by the Secretary of State for Communities and Local Government. No exceptions have been identified.

1.4 The Council has delegated the management of the Fund's investments to professional investment managers, appointed in accordance with the LGPS regulations, whose activities are specified in either detailed investment management agreements or subscription agreements and regularly monitored. The Board is satisfied that the appointed fund managers have sufficient expertise and experience to carry out their role

1.5 The LGPS is established by statute. The Pension Fund is a legally distinct entity with contributions made by employees (fixed percentage of earnings) and employers. The primary objective of the Fund is to maximise performance and so minimise the level of employer contributions in order to meet the cost of pension benefits as required by statute. A related objective is to minimise the volatility of employer contribution rates as investment returns vary from year to year.

Investment Objectives

2.1 The investment objective of the Fund is to achieve a return that is sufficient to meet the primary funding objective as set out above, subject to an appropriate level of risk (implicit in the target) and liquidity. Over the long-term, it is expected that the Fund's investment returns will be at least in line with the assumptions underlying the actuarial valuation.

Investment style

3.1 It is the Council's current policy that external fund managers are employed to administer the Fund's assets. The current structure as set out in the table below was implemented following the Pension Fund Committee meeting on 6th March 2013, at which it was decided to invest 10% of the Fund in two multi-asset mandates amounting to £27 million in each of Barings and Standard Life. This was funded by a reduction in equities together with the use of cash. The assets of the fund are mostly in “growth assets” i.e. those expected to generate additional (‘excess’) returns over the long term. These include equity, and private equity. The asset allocation also has a small allocation to “cash flow matching” assets, mainly index linked bonds. Corporate bonds, property and alternatives provide both diversification and expected returns in excess of liabilities.

The table below shows the asset allocation structure.

Asset Class	Allocation	Range	Approach
UK Equities	26%		Passive
Overseas Equities	36%		Active Global Strategy
Total Equities	62%	57-67%	
Bonds	13%	11-15%	Active Sterling aggregate benchmark plus gilts
	Corporate bonds 10.4%		
	Index Linked gilts 2.6%		
Alternatives:-	10%	8-12%	
Property	10%	8-12%	Active Management
Private Equity	5%	N/A	Active Management
Total	**100%**		

3.2 The above allocations, ranges and the management structure comply with the limits set out in table 1 of The Regulations with the exception that the limit on single insurance contracts has been increased from 25% to the upper limit of 35% to permit investment in a passive UK equity portfolio. This decision will apply until the completion of the next strategic review or if earlier 31st March 2016. The decision to increase the limit complies with The Regulations.

3.3 The investment style is to appoint fund managers with clear performance benchmarks and place maximum accountability for performance against that benchmark with the investment manager. Multiple fund managers are appointed to give diversification of investment style and spread of risk. The fund managers appointed are mainly remunerated through fees based on the value of assets under management, although remuneration through fees based on commitments and also performance related fees are also in place.

3.3 The investment strategy is reviewed periodically, with a major review taking place following each triennial actuarial review.

3.4 Cash balances are held in Pension Fund bank accounts.

3.5 Actual asset allocations are monitored against the above structure and rebalanced as appropriate. The Section 151 officer has delegated authority to undertake a quarterly rebalancing of the equity and bond portfolios should they breach the above ranges. Rebalancing within the bond portfolio is delegated to the fund manager.

3.6 Where appropriate, custodians are appointed to provide trade settlement and processing and related services. Where investments are held through funds, the fund appoints its own custodian.

3.7 A currency hedge equal to 50% on the non sterling equity exposure is maintained.

3.8 The Council does not engage in stock lending activities.

Performance

4.1 Performance targets are set on a three-year rolling basis in relation to the benchmark. The investment managers' performance is reviewed at quarterly and annual intervals by the WM Company who provides independent performance statistics.

Types of investments

5.1 A management agreement is in place for each fund manager, setting out, where relevant, the benchmark, performance target and asset allocation ranges. The agreements also set out any statutory or other restrictions determined by the Council. Investment may be made in accordance with the Regulations in equities, fixed interest and other bonds and property, in the UK and overseas markets. The Regulations specify other investment instruments that may be used, for example, financial futures, traded options, insurance contracts, stock lending, sub-underwriting contracts.

5.2 The Regulations also specify certain limitations on investments. Principally, these place a limit of 10% of the whole fund in any single holding, or deposits with a single bank or institution, or investments in unlisted securities. The Council does however have discretion to adopt a higher statutory limit in respect of specific investments subject to formal agreement by the Council.

Investment Risk

6.1 Whilst the objective of the Council is to maximise the return on its investments, it recognises that this has to be within certain risk parameters and that no investment is without an element of risk. The Council acknowledges that the predominantly equity based investment strategy may entail risk to contribution stability, particularly due to the short term volatility that equity investments can involve. The longer term nature of the fund and the expected higher longer term returns expected of equity investments over bonds mean, however, that a high equity allocation remains an appropriate strategy for the Fund. Total risk arising from the investment strategy and its implementation is monitored as part of the tri-annual strategy review. Control ranges have been set to aid the monitoring of return and risk targets.

6.2 A policy of diversification for its investments and investment managers helps the Council to mitigate overall risk. Benchmarks and targets against which investment managers are expected to perform are further measures put in place to manage the risks for the fund. Manager performance is monitored quarterly with investigation of any significant deviations from intended strategy.

6.3 The fund has a positive cash flow that enables investment in illiquid asset class's e.g. private equity and property. More than 70% of the fund is invested in equities and bonds that are highly liquid.

6.4 The Council has established a currency hedge covering 50% of the global equity portfolio to dampen the effect of foreign currency fluctuations against sterling.

6.5 Demographic factors including the uncertainty around longevity / mortality projections (e.g. longer life expectancies) contribute to funding risk. There are limited options currently available to fully mitigate or hedge this risk. The Council monitors liabilities using quarterly funding estimates from the Actuary together with a specialist service (Club Vita) which provides a comprehensive analysis of the Fund's longevity data to enable them to understand and manage this issue in the most effective way.

The realisation of investments

7.1 A realisable (liquid) investment is one that can be readily converted into cash, for example to satisfy payments out of the Fund. The majority of the Fund's assets are highly liquid and the Council is satisfied that the Fund has sufficient liquid assets to meet all expected and unexpected demands for cash. Assets in the Fund that are considered to be illiquid include property and private equity. As a long term investor the Council considers it prudent to include illiquid assets in its strategic asset allocation in order to benefit from the additional diversification and extra return this should provide.

7.2 The Council has delegated to the fund managers responsibility for the selection, retention and realisation of assets.

Investment advice

8.1 Professional advice on investment matters is taken from the investment practice of Aon Hewitt. Hymans Robertson provide actuarial services.

Social, environmental or ethical

9.1 The extent to which social, environmental and ethical considerations are taken into account in these decisions is left to the discretion of the fund managers. However, the Council expects that the extent to which social, environmental and ethical issues may have a financial impact on the portfolio will be taken into account by the fund managers in the exercise of their delegated duties. The Council expects the fund managers to positively engage and seek to influence companies in which the Fund invests to take account of key social, environmental and ethical considerations.

Exercise of the rights (including voting rights) attaching to investments

10.1 The Council is an active shareholder and will exercise its rights (including voting rights) to promote and support good corporate governance principles which in turn will feed through into good investment performance.

10.2 In practice, the Fund's equity holdings are wholly invested through pooled funds in which voting and engagement decisions are made by the fund manager. The Council encourages its fund managers to vote and engage with investee companies worldwide to ensure they comply with best practice in corporate governance in each locality. The fund managers provide reports on their voting and engagement activities.

Myners

11.1 The Myners principals codify best practice in investment decision-making. While they are voluntary, pension fund trustees are expected to consider their applicability to their own fund and report on a 'comply or explain' basis how they used them. The Regulations require administering authorities to publish in their Statement of Investment Principles the extent to which they comply with the six new investment principles set out in the Myners report on Institutional Investment. The principles and best practice guidance are attached in Appendix 1.

11.2 The Council do broadly comply with the principles but will continue to examine the requirements of the Myners principles with a view to ensuring greater compliance. Any changes will be reflected in updated versions of the Statement of Investment Principles

Additional Voluntary Contributions (AVC)

12.1 In line with statute, the Council has to appoint AVC providers and the current providers are Clerical Medical and Prudential.

Compliance

13.1 The Council is responsible for monitoring the Fund's overall investment performance and the performance of each manager**.**

13.2 The Council is responsible for monitoring the qualitative performance of the fund managers to ensure that they remain suitable for the Fund. These qualitative aspects include changes in ownership, changes in personnel, and investment administration.

13.3 The Council will regularly review the Scheme's compliance with this Statement of Investment Principles. The Statement is reviewed at least every three years and in addition a revised version is issued in the event of significant change occurring.

Appendix 1

Myners Principles:
Defined Benefit Pension Schemes

1. Effective decision-making

Trustees should ensure that decisions are taken by persons or organisations with the skills, knowledge, advice and resources necessary to take them effectively and monitor their implementation.

Trustees should have sufficient expertise to be able to evaluate and challenge the advice they receive, and manage conflicts of interest.

<u>Best Principle Guidance</u>

• The board has appropriate skills for, and is run in a way that facilitates, effective decision making.

• There are sufficient internal resources and access to external resources for trustees and boards to make effective decisions.

• It is good practice to have an investment sub-committee, to provide the appropriate focus and skills on investment decision-making.

• There is an investment business plan and progress is regularly evaluated. [(Not as such, although an annual plan of issues for discussion is maintained].

• Consider remuneration of trustees. [Additional remuneration for membership of the Committee is not required].

• Pay particular attention to managing and contracting with external advisers (including advice on strategic asset allocation, investment management and actuarial issues).

2 Clear objectives

Trustees should set out an overall investment objective(s) for the fund that takes account of the scheme's liabilities, the strength of the sponsor covenant and the attitude to risk of both the trustees and the sponsor, and clearly communicate these to advisers and investment managers.

<u>Best Practice Guidance</u>

• Benchmarks and objectives are in place for the funding and investment of the scheme.

• Fund managers have clear written mandates covering scheme expectations, which include clear time horizons for performance measurement and evaluation.

• Trustees consider as appropriate, given the size of fund, a range of asset classes, active or passive management styles and the impact of investment management costs when formulating objectives and mandates.

• Consider the strength of the sponsor covenant.

3 Risks and Liabilities

In setting and reviewing their investment strategy, trustees should take account of the form and structure of liabilities. These include the strength of the sponsor covenant, the risk of sponsor default and longevity risk.

Best Practice Guidance

• Trustees have a clear policy on willingness to accept underperformance due to market conditions.

• Trustees take into account the risks associated with their liabilities' valuation and management.

• Trustees analyse factors affecting long-term performance and receive advice on how these impact on the scheme and its liabilities.

• Trustees have a legal requirement to establish and operate internal controls.

• Trustees consider whether the investment strategy is consistent with the scheme sponsor's objectives and ability to pay.

4 Performance Assessment

Trustees should arrange for the formal measurement of the performance of investments, investment mangers and advisors. Trustees should also periodically make a formal policy assessment of their own effectiveness as a decision-making body and report on this to scheme members.

Best Practice Guidance

• There is a formal policy and process for assessing individual performance of trustees and managers. [Formal performance assessments are limited to fund managers].

• Trustees can demonstrate an effective contribution and commitment to the role (for example measured by participation at meetings).

• The chairman addresses the results of the performance evaluation.

• State how performance evaluations have been conducted.

• When selecting external advisers take into account relevant factors, including past performance and price.

5 Responsible Ownership

Trustees should adopt, or ensure their investment managers adopt, the Institutional Shareholders' Committee (ISC) Statement of Principles on the responsibilities of shareholders and agents.
A statement of the scheme's policy on responsible ownership should be included in the Statement of Investment Principles.
Trustees should report periodically to members on the discharge of such responsibilities.

<u>Best Practice Guidance</u>

• Policies regarding responsible ownership are disclosed to scheme members in the annual report and accounts or in the Statement of Investment Principles.

• Trustees consider the potential for engagement to add value when formulating investment strategy and selecting investment managers.

• Trustees ensure that investment managers have an explicit strategy, setting out the circumstances in which they will intervene in a company.

• Trustees ensure that Investment consultants adopt the ISC's Statement of Practice relating to consultants.

6 Transparency and Reporting

Trustees should act in a transparent manner, communicating with stakeholders on issues relating to their management of investment, its governance and risks, including performance against stated objectives.
Trustees should provide regular communication to members in the form they consider most appropriate.

<u>Best Practice Guidance:</u>

• Reporting ensures that the scheme operates transparently and enhances accountability to scheme members and best practice provides a basis for the continuing improvement of governance standards.

REPORT FOR: Pension Fund Committee

Date of Meeting:	25th June 2013
Subject:	Equity Training and Beliefs
Responsible Officer:	Simon George, Director of Finance and Assurance
Exempt:	No.
Enclosures:	.Aon Hewitt training material

Section 1 – Summary and Recommendations

With the completion of the strategic asset allocation review, this paper focuses on the equity component and discusses the options for structuring an equity portfolio. The purpose is to agree a basis for further training and the development of more precise proposals that reflect the Committee's views.

Recommendation:

None. The Committee views will be noted and used to develop future training and detailed proposals.

Harrow COUNCIL LONDON

Section 2 – Report

1. With the completion of the strategic asset allocation review it is appropriate to consider the structure and composition of each asset class to ensure that the fund is achieving the best balance of return and risk and to test whether the assets are being managed in accordance with the Committee's investment beliefs. Listed equities represent 62% of the strategy and are a good place to start this process.

2. Currently, the portfolio is managed by 4 fund managers, with 42% UK passive (1 manager) and 58% global active (3 managers). The current arrangements were put in place in 2009.

3. The attached paper from Aon Hewitt considers the current structure and the factors that should be considered when structuring an equity portfolio. The paper is not intended to offer solutions but to facilitate a debate on the beliefs, assumptions and forecasts that should influence the equity portfolio construction. In doing so, we can test whether the current structure chimes with the Committees beliefs and expectations and represents the optimum way to manage equities.

4. The factors that the Committee will be asked to consider when going through the training material include:

   a) Geographic allocations

   - The rationale for a specific UK equity allocation given that currency risks can be managed with hedges. With most UK equity earnings deriving from overseas and UK equity returns expected to trail overseas equities, they don't appear to be a better match for our pension fund liabilities.
   - The UK represents around 10% of the global equity market, yet the current allocation is 42%.
   - Emerging markets generate most economic growth and represent most of the global population, but little more than 10% of the stock market indices. Do expectations of wealth rebalancing justify a higher / explicit allocation to emerging markets?

   b) Active / passive

   - Do active managers exist who can reliability add value after costs?
   - In all or only some markets?
   - If so, can the Committee identify and monitor these relationships? Evidence from WM has been that active management does not **on average** deliver superior returns to LGPS.
   - Are others better placed to identify and monitor active managers on our behalf e.g. delegated manager selection?
   - Are alternatives to market capitalisation based indices a basis for passive management? Although historic performance of alternative indexation is superior to traditional passive, the reasons are often unclear and the ability to predict future returns uncertain.

c) Mandate structure

- Which styles of active management work best e.g. low risk highly diversified core through to concentrated / benchmark unconstrained portfolios?

5. At this stage, the Committee's views on the questions / options raised are sought. In some cases, more training will be required before any decisions can be made e.g. alternative passive benchmarks. Hopefully, the Committee will at least talk through the framework on page 19 of the Aon report. The views of the Committee will be used to develop more precise proposals and training for the September meeting. Suggested topics for future training topics include:

- Alternative passive methodologies
- The case for a targeted emerging market exposure
- Fiduciary / delegated management

Financial Implications

6. The equity structure will have a significant impact on ability to meet and exceed the returns required to restore full funding.

Risk Management Implications

7. Risk included on Directorate risk register? No

8. Separate risk register in place? No

9. Setting risk tolerances and measuring outcomes is central to the strategy.

Equalities implications

10. Was an Equality Impact Assessment carried out? Yes

11. There are no direct equalities implications relating to the pension fund.

Corporate Priorities

12. Corporate Priorities are not applicable to the Pension Fund as it does not have a direct impact on Council resources.

Legal Implications

13. The report has been reviewed by Legal Department and comments received are incorporated into the report.

Section 3 - Statutory Officer Clearance

Name: Simon George Date: 10 June 2013	√	Chief Financial Officer
Name: Matthew Adams Date: 10 June 2013	√	Monitoring Officer

Section 4 - Contact Details and Background Papers

Contact: George Bruce (Treasury and Pension Fund Manager) Tel: 020-8424-1170 / Email: george.bruce@harrow.gov.uk

Background Papers: Papers and training material relating to investment strategy provided to the PFIP meetings on 8 January 2013 and at various meetings in 2011 and 2012.

If appropriate, does the report include the following considerations?

1.	Consultation	N/A
2.	Corporate Priorities	N/A

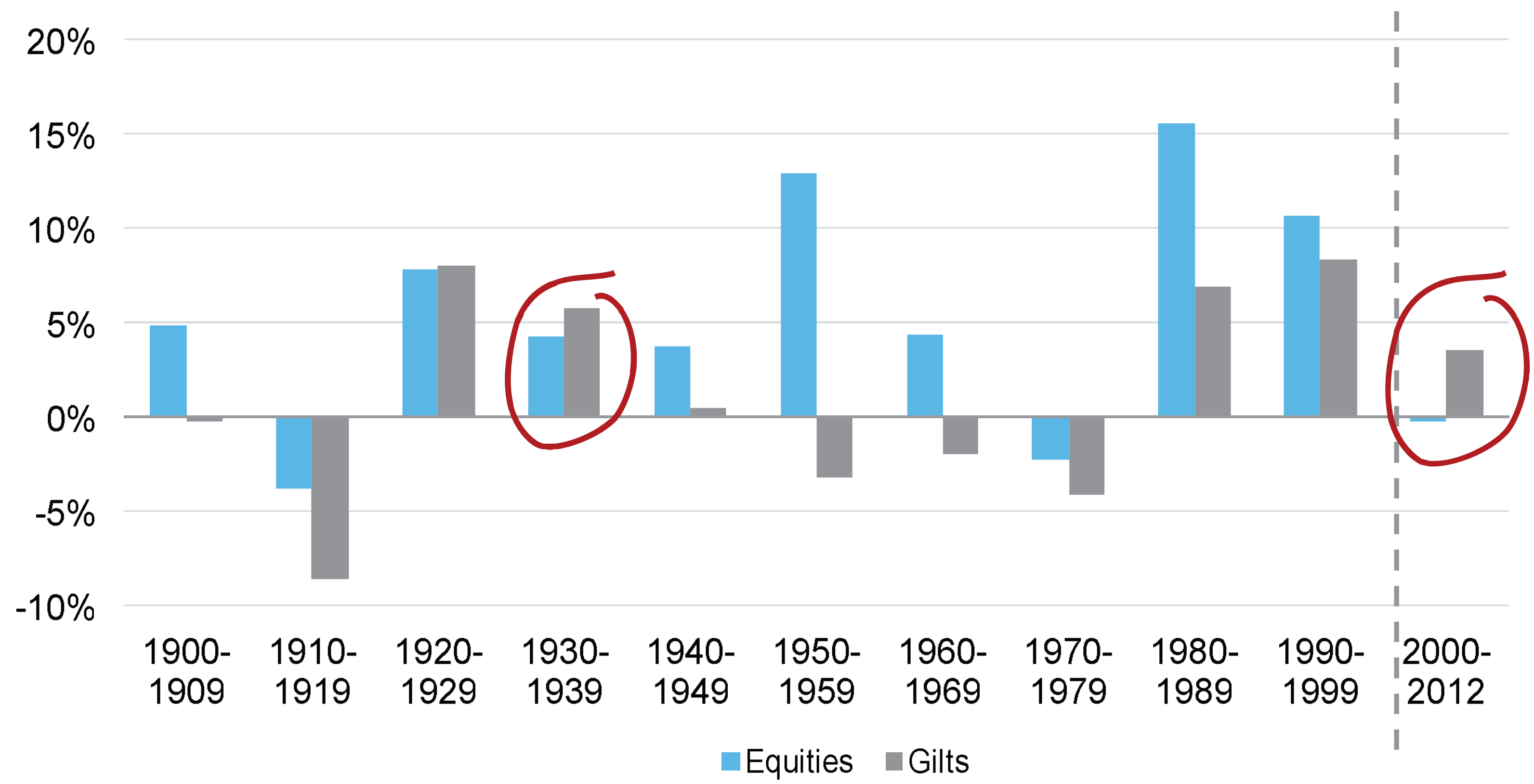

London Borough of Harrow
Pension Fund
Equity Training
30 May 2013
Tony Baily
Stephanie Randall
AON Hewitt

Agenda

1. Role of equities
2. Your asset allocation
3. Management approaches
4. Geographic allocation
5. Implementation
6. Next steps

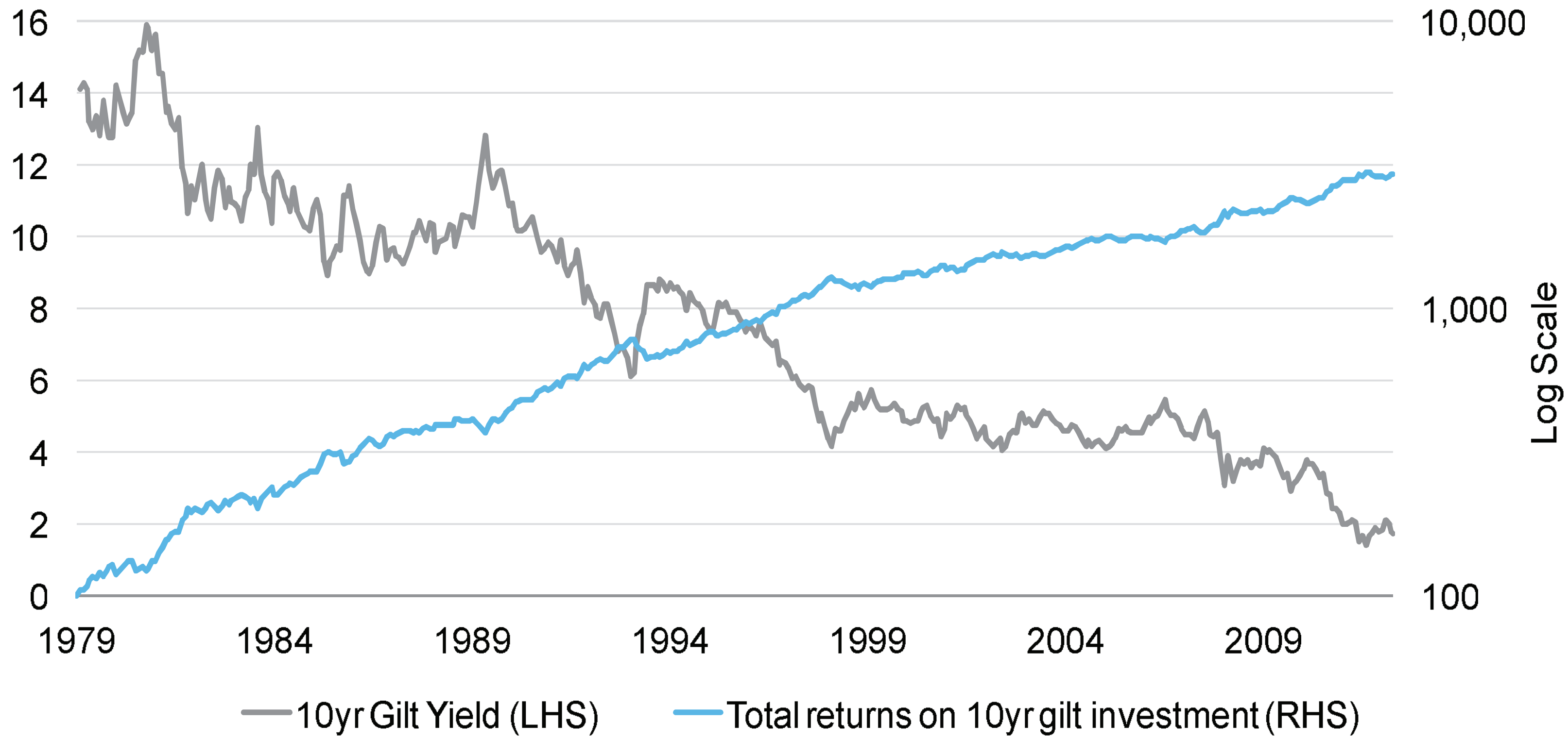
Recent equity-bond performance has been anomalous

Real equity and gilt returns over time (relative to RPI)



Source: Barclays, Aon Hewitt

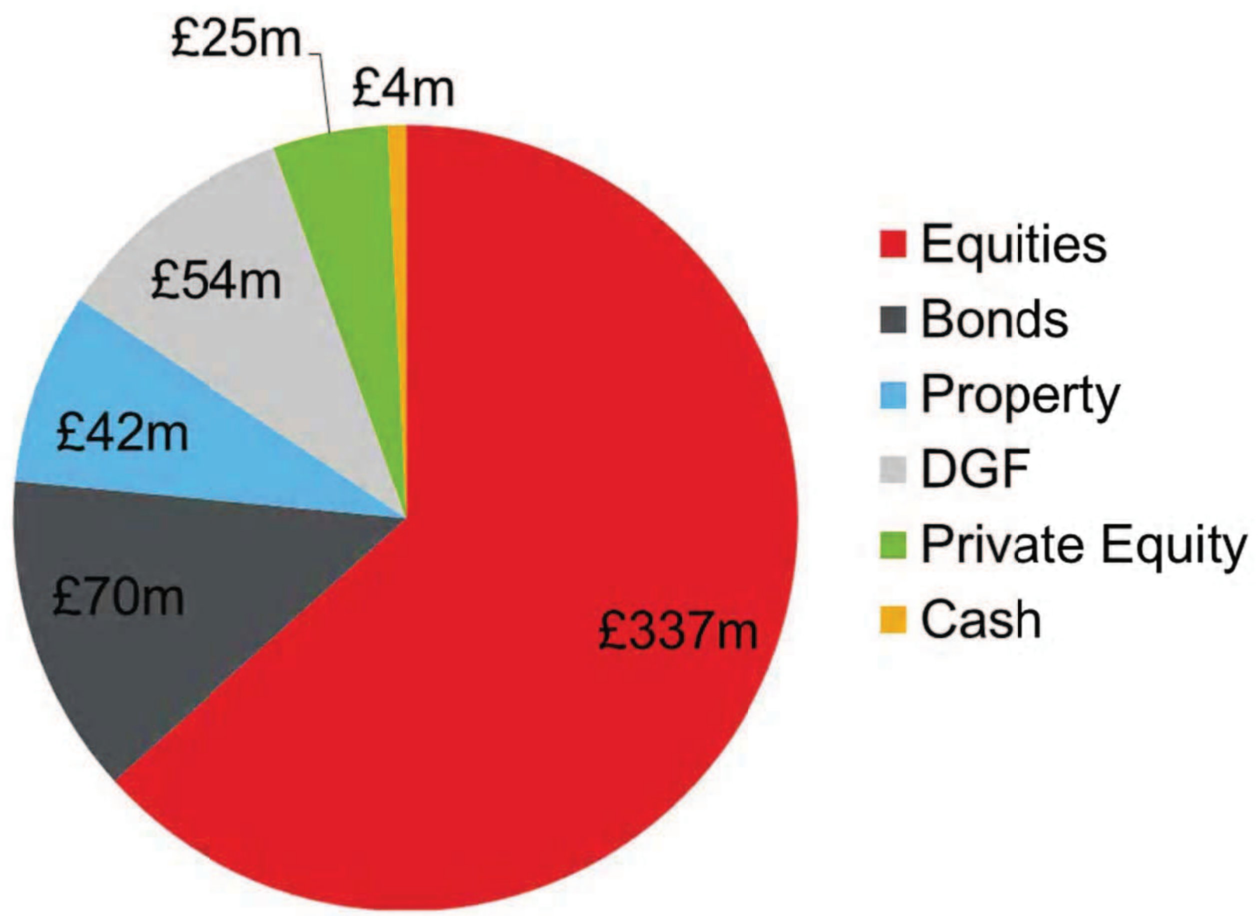
Bond returns have been boosted by high historic yields and secular downtrend in yields



Source: Datastream

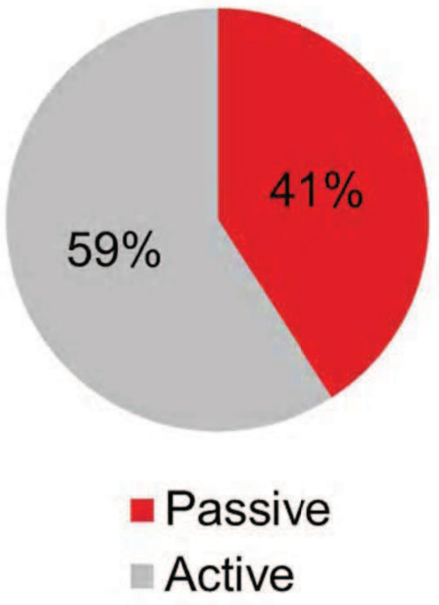
Agenda

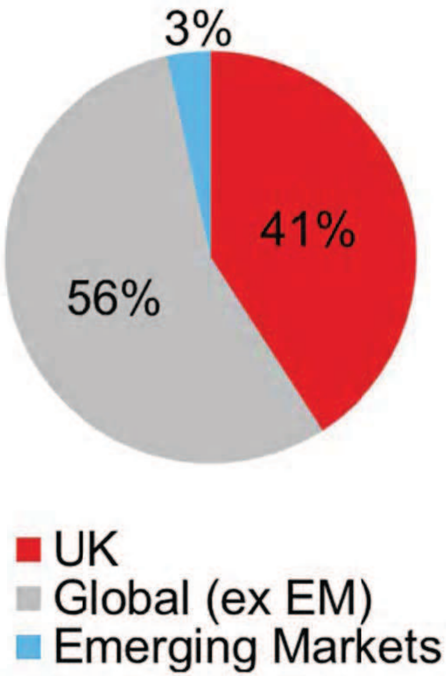
Current asset allocation

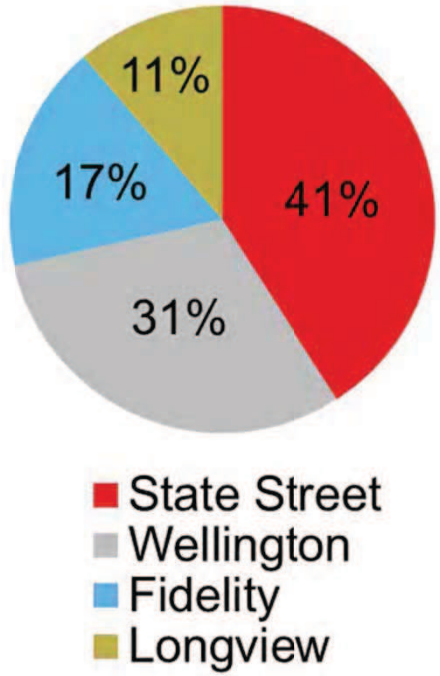


Current equity allocation

Estimated return over 10 years:	8.8% p.a.
Estimated annual volatility:	21.8%





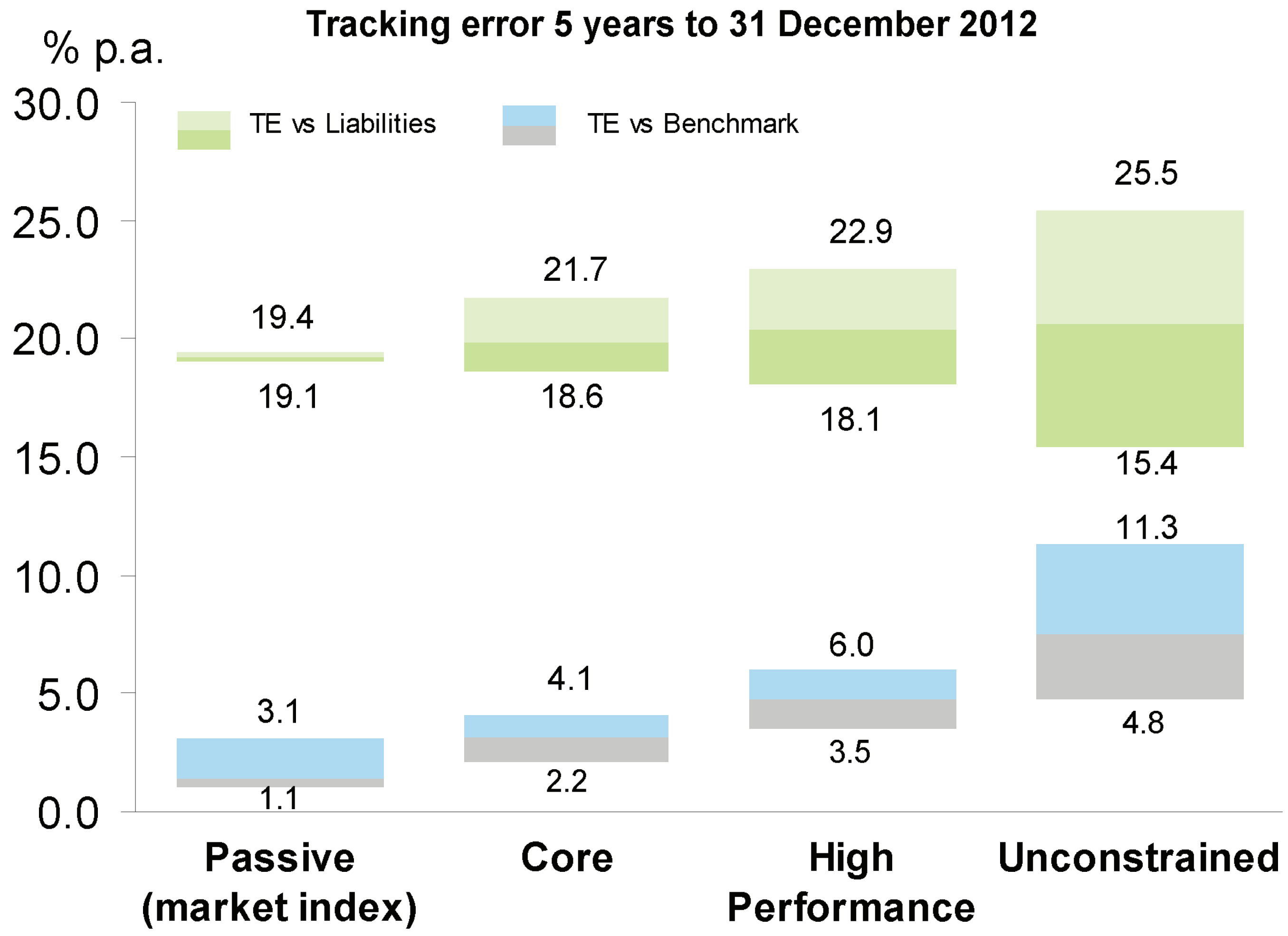


Agenda

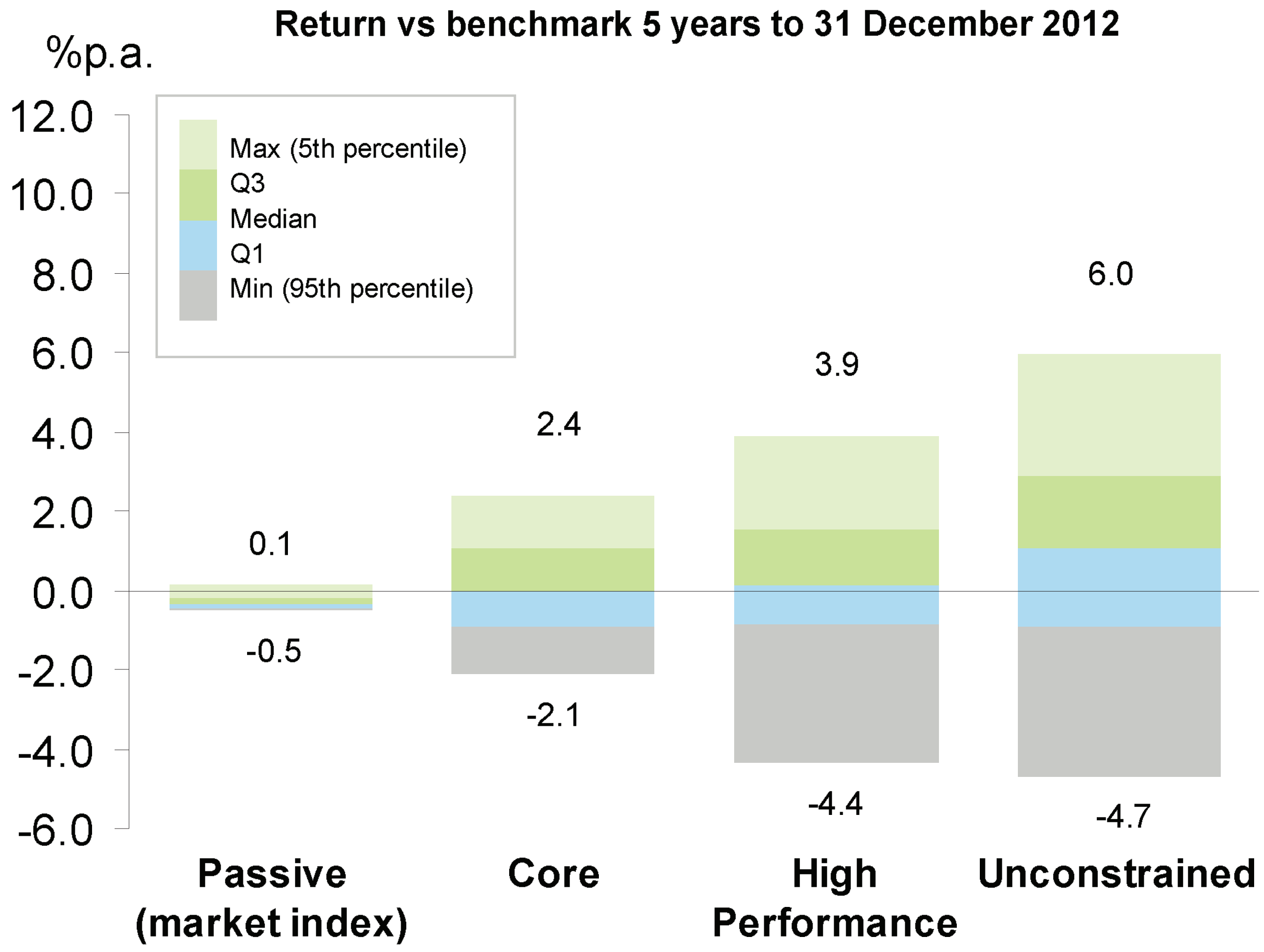
Comparing management approaches

Passive	Aim to match market cap index returns	Fees 5 to 200 bp		
Alternative Indexation	Aim to match alternative index returns			
Traditional Active	Aim to outperform index by + 1%			
High Performance	Aim to outperform index by ≥ + 2%			
Unconstrained	Managers focus on absolute returns			

Is passive really low risk?



Does it work in practice?

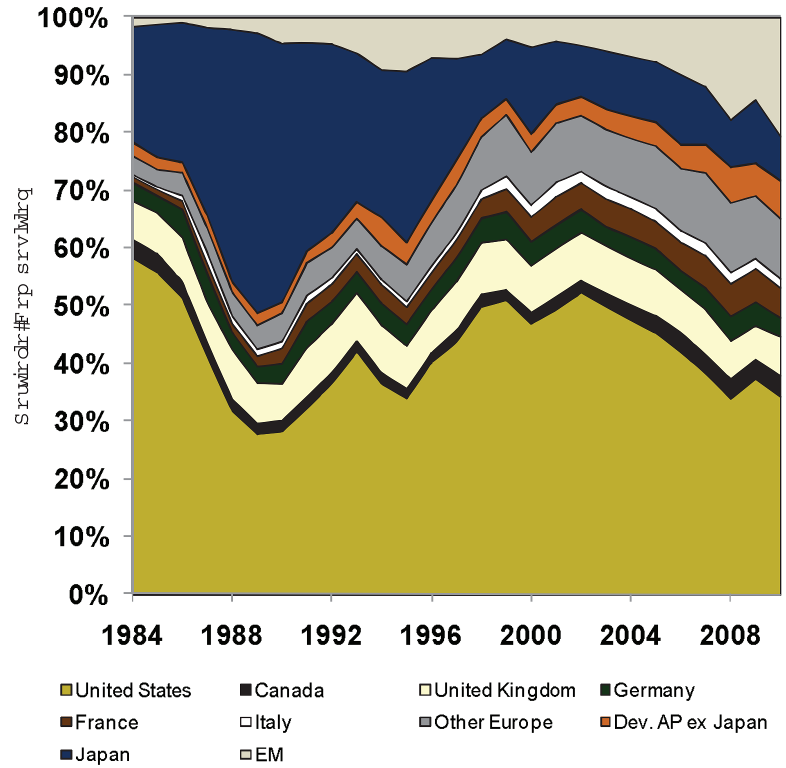


Alternative indexation – the challenge

- Cap weighted indices have long been the standard approach

- But markets can be prone to bubbles!

- Is there a more appropriate approach?
  – Unconstrained investing
  – Alternative indexation



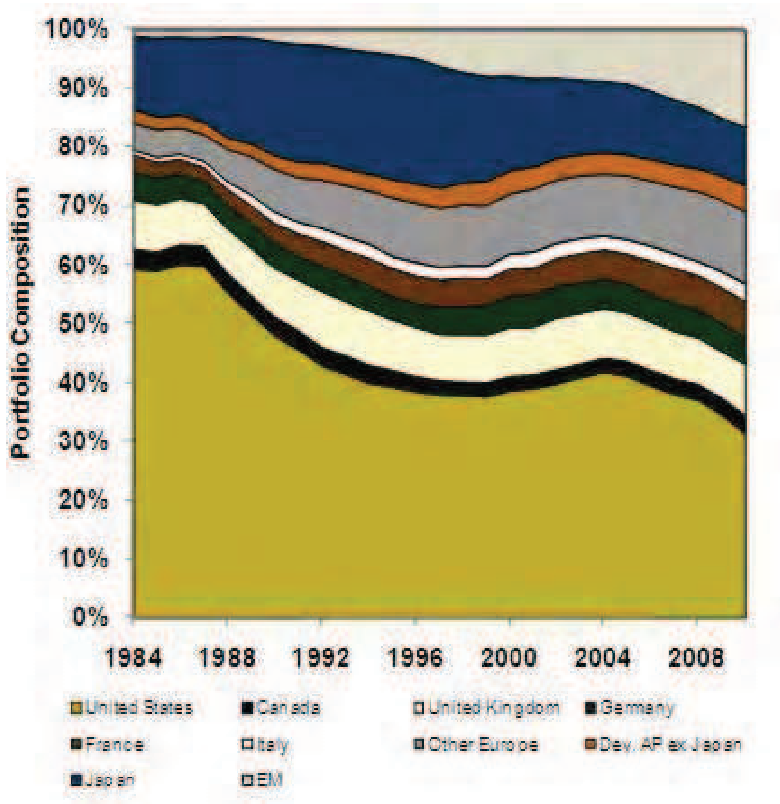
Source: Research Affiliates, LLC.
Based on data from CRSP, Compustat, Datastream, and Worldscope.
Country Weights: All World 3000

Alternative indexation – what is it?

- Weight stocks by factors other than market cap

- Improve portfolio diversification
  – Equal weighting

- Seek returns from alternative risk factors
  – Low volatility
  – Value



Source: Research Affiliates, LLC.
Based on data from CRSP, Compustat, Datastream, and Worldscope.
Rolling 12-Month Averages: 1984–2010

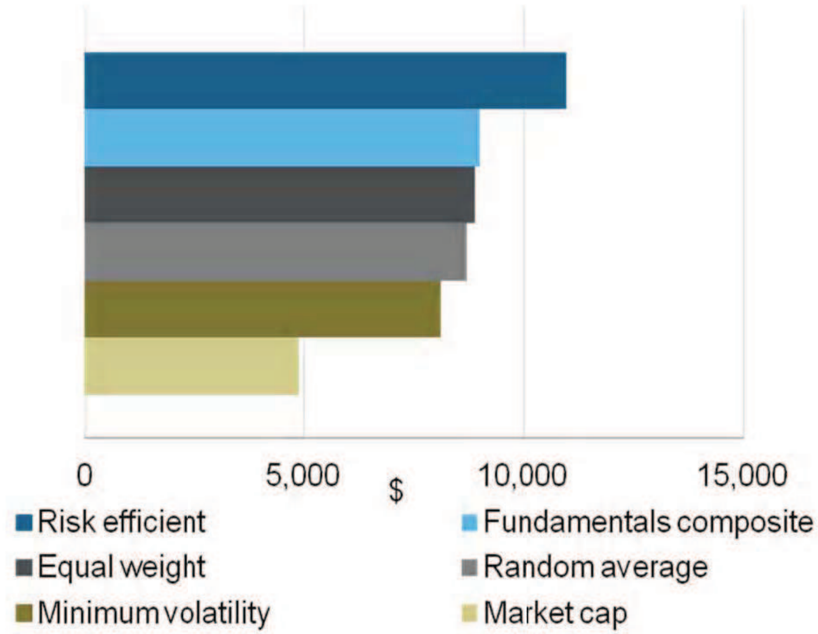
Alternative indexation – the opportunity

- The majority of schemes still need returns from equity markets

- We are working closely with Cass Business School
  - Identifying alternative approaches
  - And the markets they work best in

- Alternative Indexation can deliver better risk-adjusted returns, but often with less liquidity and higher turnover

- Proceeds at end of 2011 of $100 invested in 1968 in US stocks using different weighting methods



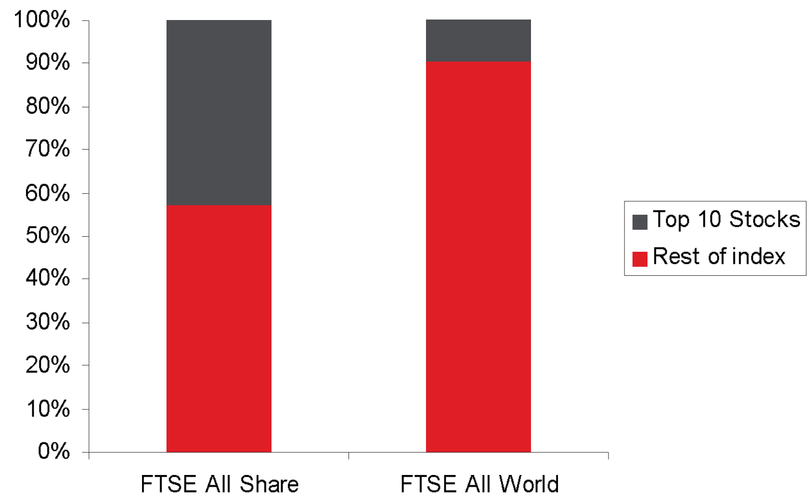
Source: "An evaluation of alternative equity indices, Part 1: Heuristic and optimised weighting schemes", and "An evaluation of alternative equity indices, Part 2: Fundamental weighting schemes", by Clare, A., N. Motson, & S. Thomas, Cass Business School, March 2013

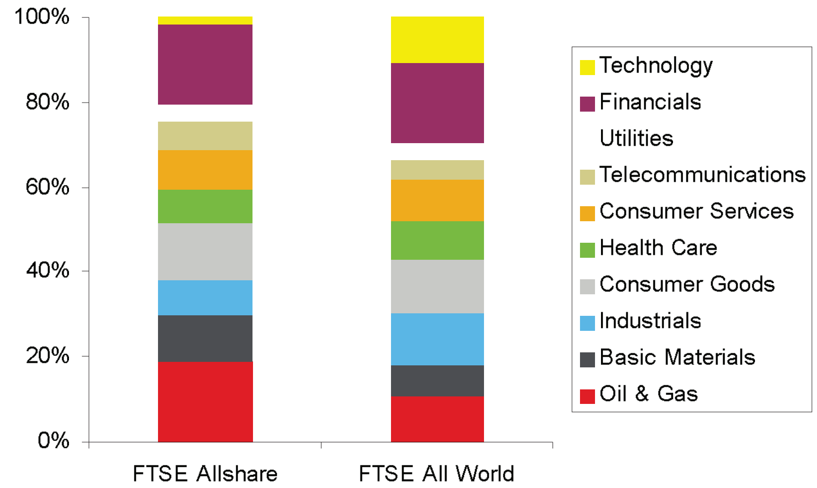
Agenda

1. Role of equities
2. Your asset allocation
3. Management approaches
4. **Geographic allocation**
5. Implementation
6. Next steps

Global versus UK investment

- Why invest globally?
  - UK equities are not necessarily UK businesses, many are multinationals. Around two thirds of UK quoted company profit comes from overseas
  - May provide better stock or sector diversification
  - If stronger returns are expected overseas
- No strong argument for UK over overseas equities
  - Previously thought that UK equities provide a better match for sterling liabilities
  - But equities are usually held as a return seeking asset
  - The decision should instead be based on expected return
  - We expect overseas equities to deliver a higher return per unit of risk and so represent a more efficient investment

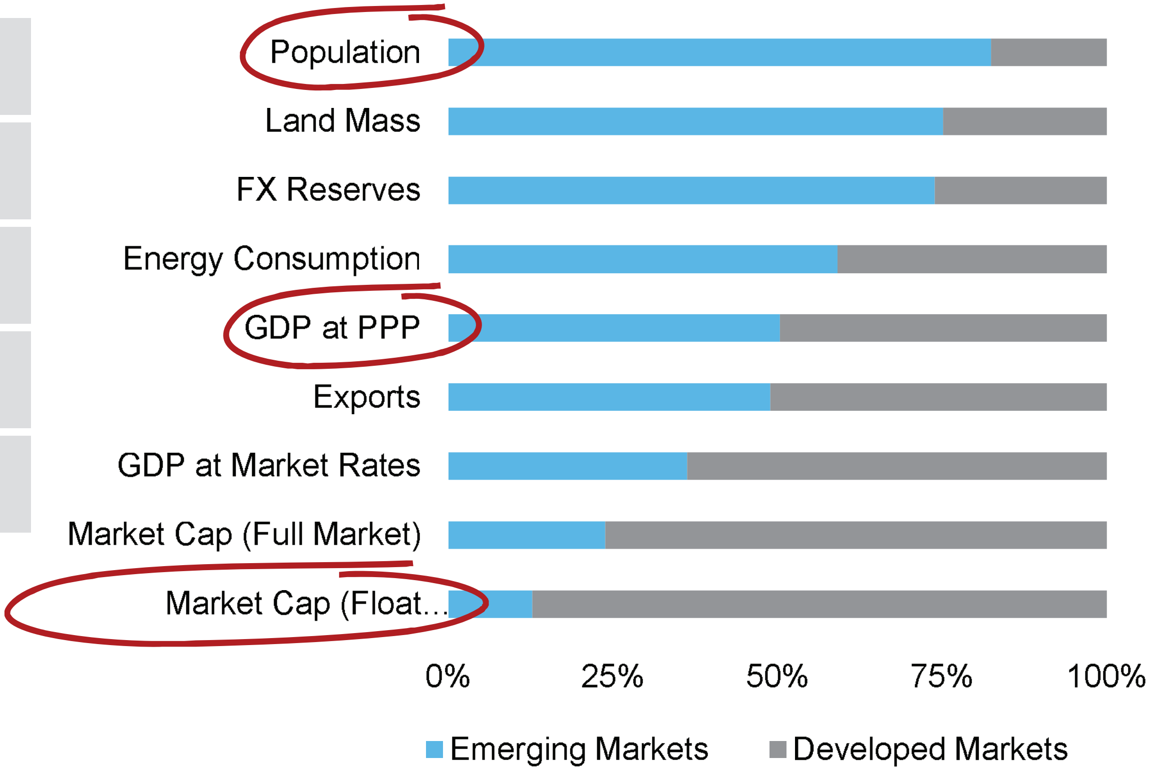




Emerging markets versus developed markets

- Developed markets are struggling…
  - Growth potential
  - Demographics
  - Resource rich
  - Fiscal position
  - Improving governance

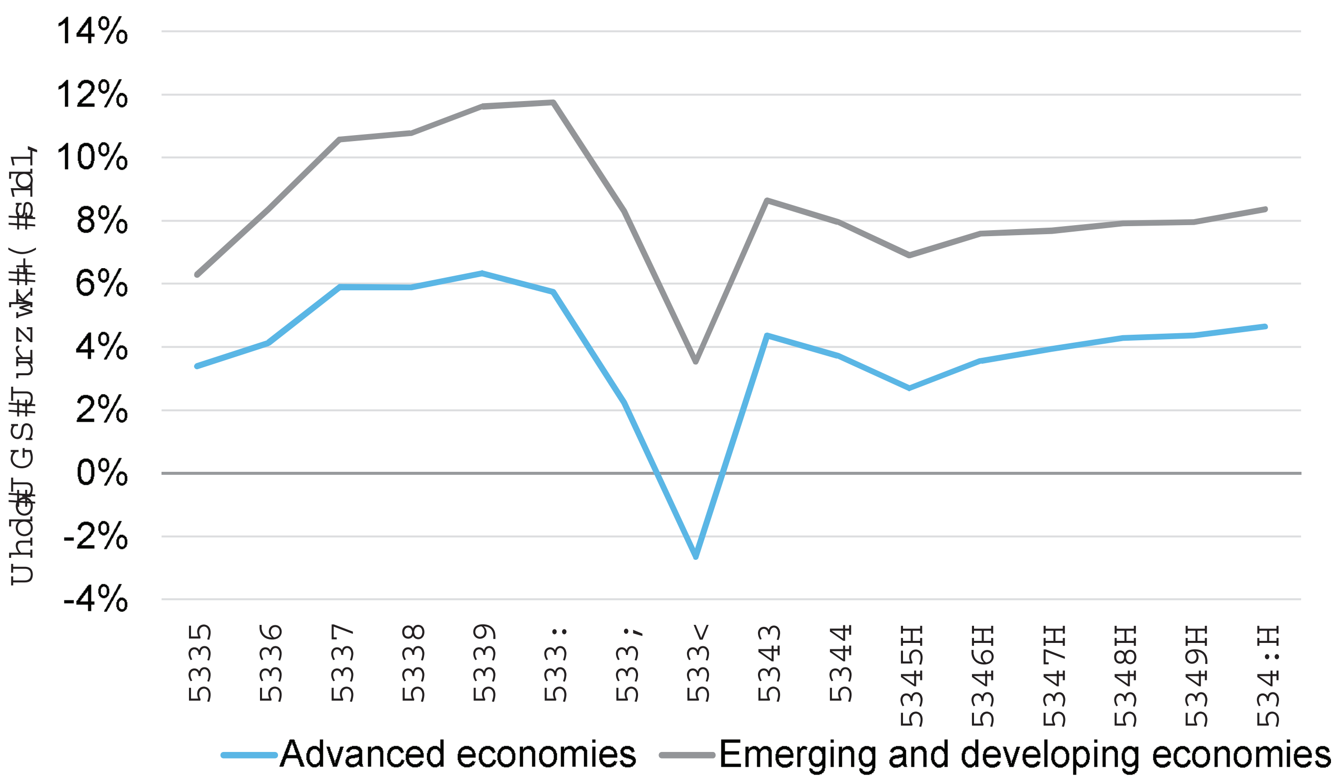
- …the global balance is changing



Source: BofA Merrill Lynch, BP, CIA World Factbook, IMF World Economic Outlook Market cap, FX reserves and population as at 6/11/12; GDP as at 30/4/12, export and energy as at 2011

Emerging markets versus developed markets

▪Real GDP growth over time



Growing domestic demand

Return expectations 1% p.a. above developed world

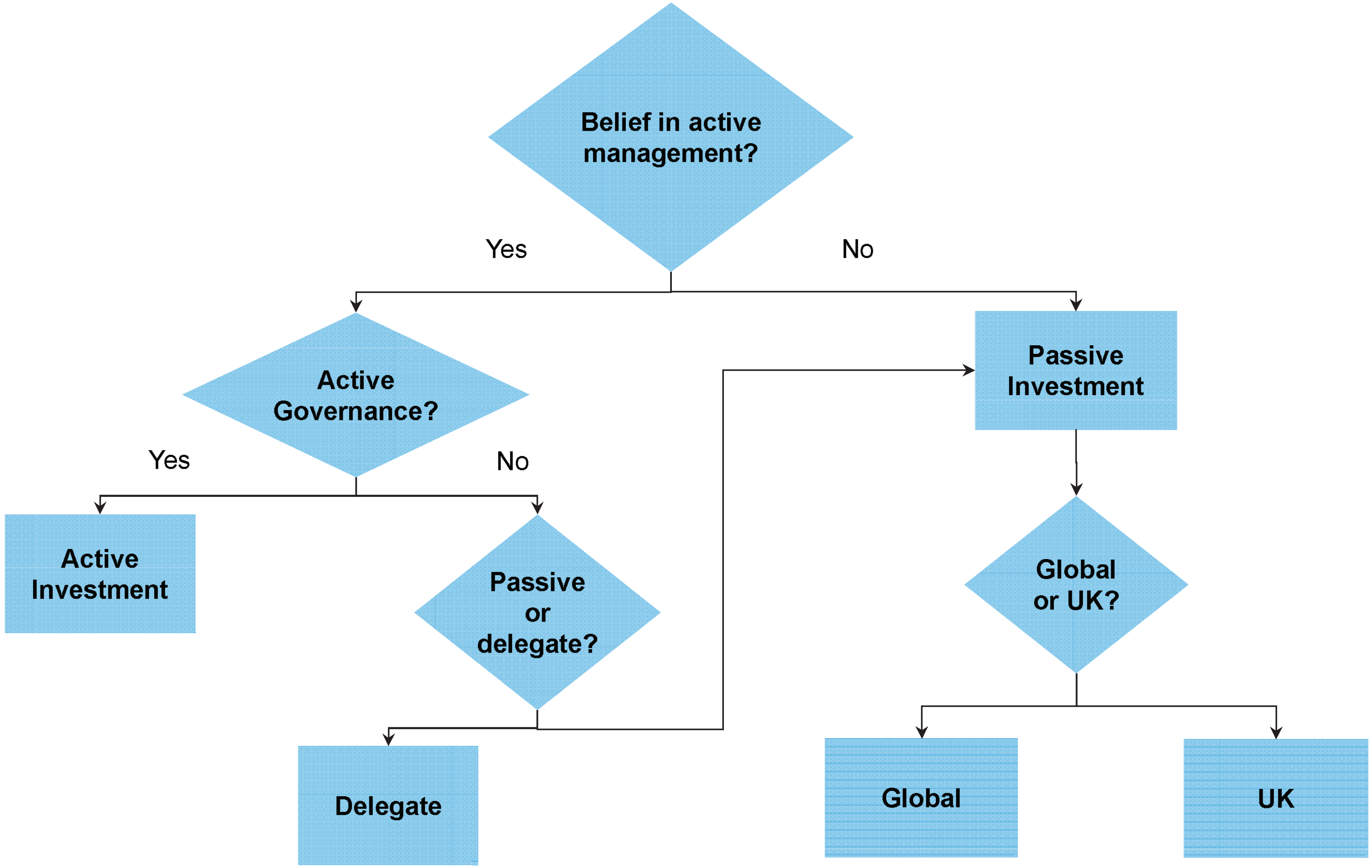
Note: Values from 2012 onwards are IMF projections

Source: IMF

Agenda

1. Role of equities
2. Your asset allocation
3. Management approaches
4. Geographic allocation
5. **Implementation**
6. Next steps

Investment beliefs and governance framework

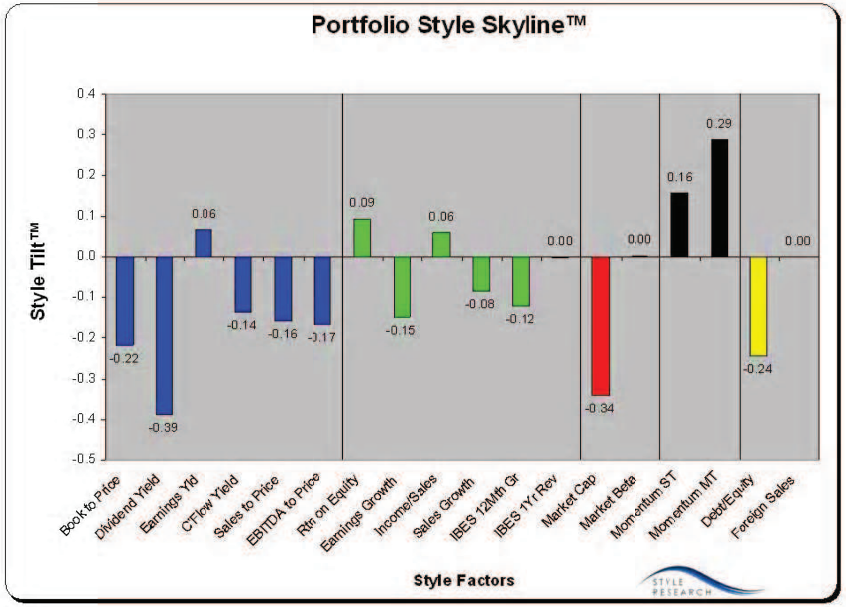


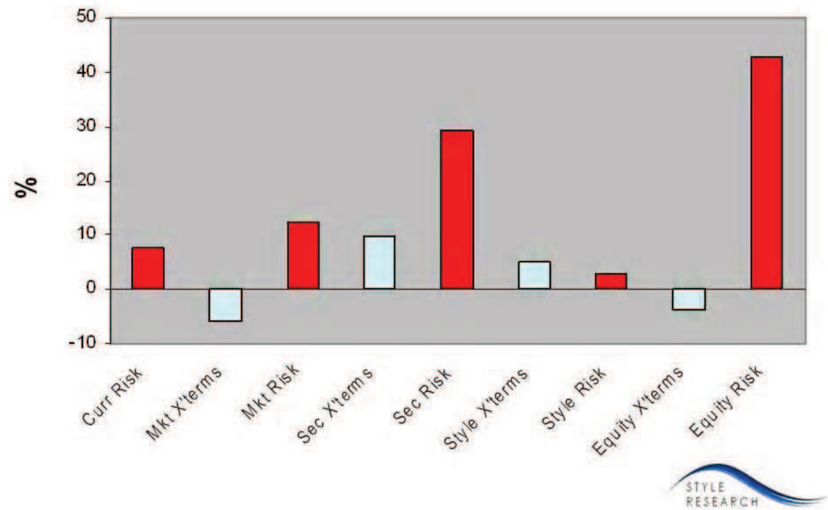
Manager allocation

All the equity managers should complement each other to ensure good diversification. We would normally suggest managers that intuitively would complement Longview.

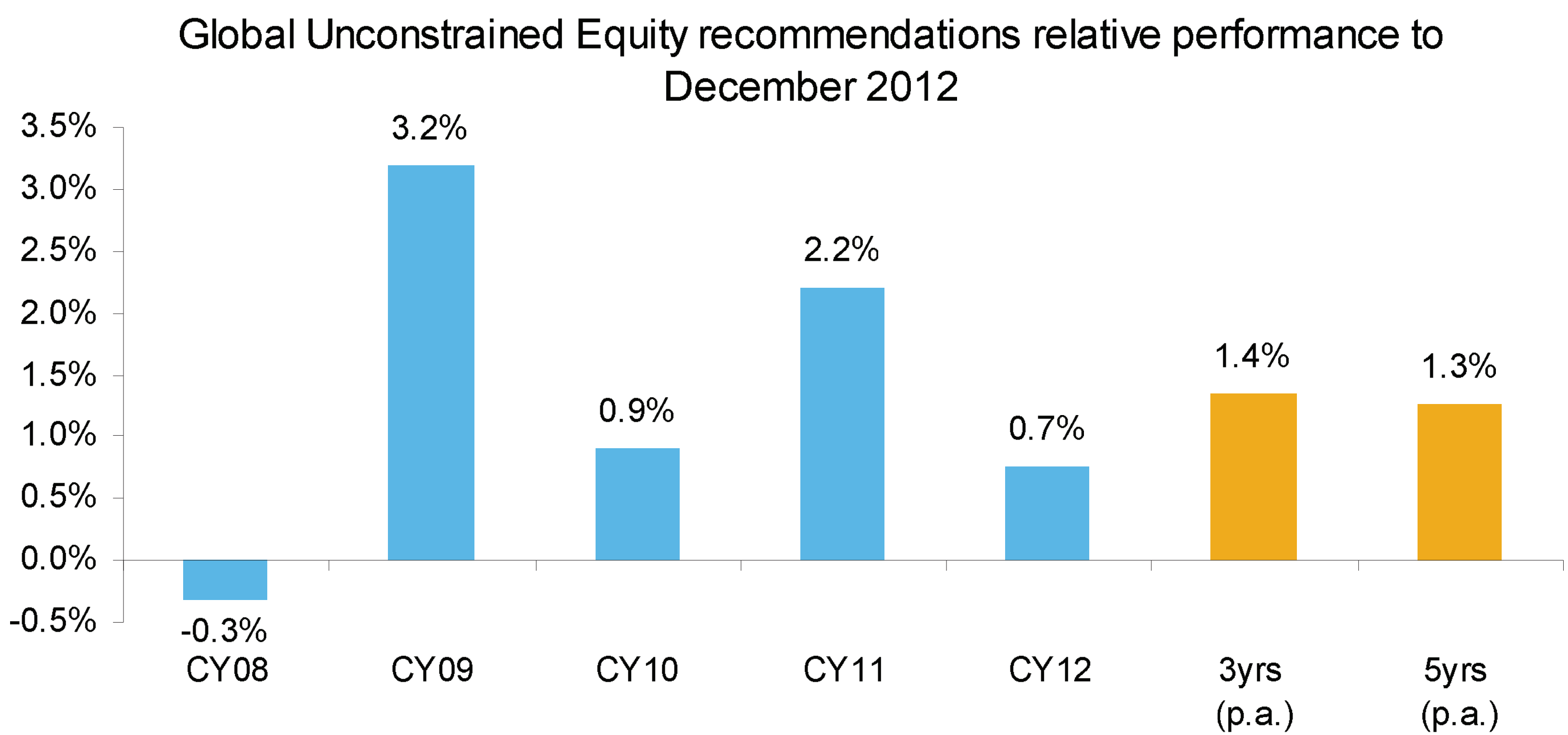
As part of a manager selection exercise we can also complete an in depth complementarity analysis to ensure that the current portfolio of any new managers complement the existing ones.

Below is a style analysis of Longview as an example of some of the output that would form our analysis.





Aon Hewitt BUY list performance



Benchmark: MSCI World untill 1 January 2011; MSCI AC World thereafter.
Source: Aon Hewitt, Fund Managers, Datastream, eVestment Alliance. Data: Gross of fees in GBP.

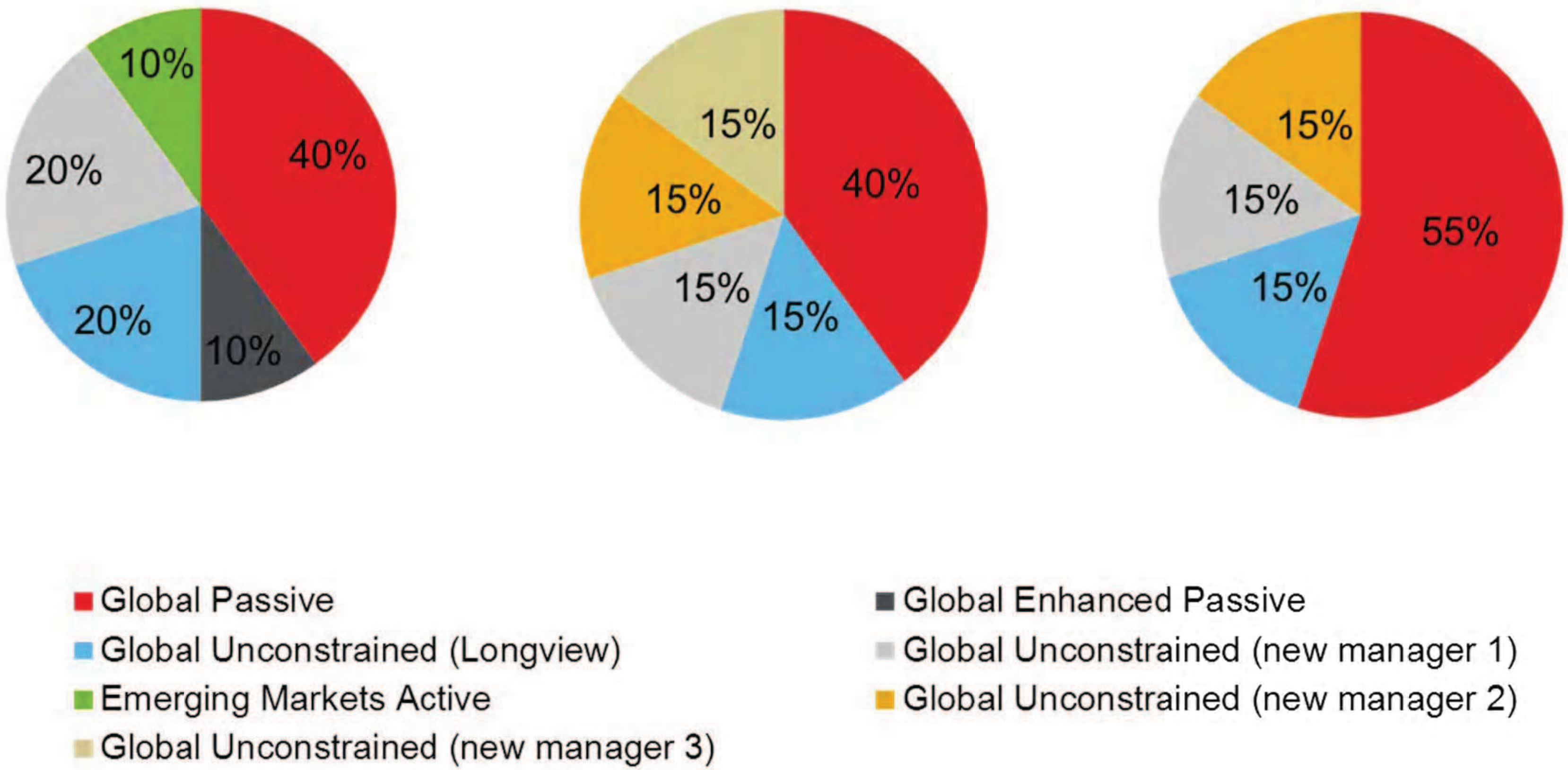
Agenda

1. Role of equities
2. Your asset allocation
3. Management approaches
4. Geographic allocation
5. Implementation
6. **Next steps**

Next steps

1. Agree investment beliefs and governance framework
2. Active or passive investment
3. Geographic focus of investments
4. Complete manager searches as necessary
5. Transition assets

Possible equity strategy options



AON Hewitt


London Borough of Harrow
Pension Fund
Equity Training –
Supporting Material
30 May 2013
AON Hewitt

Reviewing equity managers – what to ask

- Limited time available for the Committee to review each manager
- Key is to focus on areas that are likely to upset the investment management process
- These can include:
  - Staff departures and arrivals
  - Inflows and outflows of client money
  - Changes to the investment process itself
  - Ownership issues
- Managers should be given a steer to cover these areas at the start of their presentations
- Once this has been done, then anything of interest to the Committee can be asked
- Short term performance can be a red herring

What are Emerging Markets?

- There is no universal definition for what an Emerging Market is, and in fact index providers use different distinctions when constructing their indices. However, broad definitions and index constituents for Developed and Emerging Markets are outlined below, along with a further group known as Frontier Markets:

Developed Markets[1]

AUSTRALIA	DENMARK	GREECE	ITALY	NORWAY	SWEDEN
AUSTRIA	FINLAND	HONG KONG	JAPAN	PORTUGAL	SWITZERLAND
BELGIUM	FRANCE	IRELAND	NERTHERLANDS	SINGAPORE	UK
CANADA	GERMANY	ISRAEL	NEW ZEALAND	SPAIN	USA

Developed markets typically exhibit higher, more stable GDP per capita with well developed investment markets and political structure. Transparency amongst market participants is better than less developed markets.

Emerging Markets[1]

BRAZIL	CZECH REPUBLIC	INDONESIA	MOROCCO	RUSSIA	TURKEY
CHILE	EGYPT	KOREA	PERU	SOUTH AFRICA	
CHINA	HUNGARY	MALAYSIA	PHILIPPINES	TAIWAN	
COLOMBIA	INDIA	MEXICO	POLAND	THAILAND	

Countries that fall into this category are generally low to middle income nations which are pursuing substantial economic and political reforms and are thus becoming more integrated into the global economy.

Frontier Markets[1]

ARGENTINA	ESTONIA	LEBANON	PAKISTAN	SRI LANKA
BAHRAIN	JORADN	LITHUANIA	QATAR	TUNISIA
BANGLADESH	KAZAKHSTAN	MAURITIUS	ROMANIA	UKRAINE
BULGARIA	KENYA	NIGERIA	SERBIA	UAE
CROATIA	KUWAIT	OMAN	SLOVENIA	VIETNAM

A frontier market is an Emerging Market in a low to low middle income country, are relatively small and illiquid and have generally less information and transparency than other Emerging Markets and/or have investment restrictions in place.

1: Based on MSCI Classification

Active manager styles

- Managers will use a wide range of sources to research stocks
  - Analyst ratings and press ratings
  - Company visits
- Analysts will use a number of key ratios to analyse stocks and build portfolios
  - Price / Earnings (P/E) ratio
  - Information ratio
  - Tracking error
  - Beta
- What is the underlying philosophy? Examples include *(see appendix for further details)*:
  - Quantitative
  - Value
  - Growth
  - Small cap
  - Momentum

Investment style – Quantitative, or “Quant”

- In general, “quant” managers use more of other people’s (brokers’) views and factual information to make their investment decisions rather than their own views on stocks
- Use mathematical models to determine:
  - Attractive stocks
  - Portfolio construction
- Generally take lots of small bets to add value

AON Hewitt

Investment style - “Value”

- Assumptions
  - Market over-reacts to bad news
  - In the long-term, fundamentals prevail
- Identify “under-rated” and “out of favour” shares
  - High dividend yields
  - Low price/earnings ratios
- “Recovery” is a variant of “Value”

Investment style - “Growth”

– Assumptions:
  - Buy equities for their future earnings
  - Bias to “growth” industries
– Identify stocks with good long-term prospects
  - Low dividend yields
  - Industries / products of the future

Investment style - “Small Cap”

- Assumptions
  - Small companies have potential to grow
  - Small companies often less well researched
  - …sometimes called “the research gap”
- Usually focussed on a specific business

AON Hewitt

Investment style - “Momentum”

- Assumptions
  - Trends can be observed in market movements i.e. if markets rise one day, they are likely to continue to carry on rising the next day
  - This is because investors’ attitudes tend to be affected by recent behaviour of markets – investors get attracted to stocks that are ‘on the up’
  - Such behaviour can be exploited by managers
- Tends to be a component of quantitative approaches

Glossary

- **Active management** is where the manager aims to outperform the index by picking the best performing stocks within that index.
- **Alpha** is often used in a generic sense to indicate outperformance. Mostly it is used to describe the difference between a fund's return and a benchmark return. This may or may not be risk-adjusted.
- **Basis point (bp)** is defined as one hundredth of 1%. So 45b.p. is equivalent to 0.45%. Basis points are used for convenience when all the percentages being discussed are small. Also abbreviated as bps.
- **Beta** is an indication of the sensitivity of a stock's movements to market movements and can be interpreted as exposure to the broad stock market. A beta of 0.7 means that if the market moves 1 unit the individual stock is expected to move 0.7 units.
- **Enhanced indexation** is where a passive manager aims to enhance the return above the benchmark modestly but does not deviate significantly from the benchmark.
- **Equity risk premium** is the extra return needed to persuade investors to hold equities rather than government bonds ("risk free investments")
- **Growth stock** A fund manager will describe a stock as a 'growth stock' if they believe that the stock has good long term growth prospects. A growth stock usually has a low dividend yield and may be in an industry or product of the future. A manager who tries to outperform the benchmark by correctly identifying growth stocks is said to have a 'growth style' or 'growth bias.'
- **Information ratio** is the ratio of portfolio excess return (alpha) to risk. It is a measure of fund manager performance as it shows how much return the portfolio is receiving in compensation for the risk being taken relative to the benchmark. The formula is as follows:

  Information ratio = Average excess return/Standard deviation of excess return.

Glossary

- **Liability Driven Investing (LDI)** is a framework for measuring your assets against your liabilities and is commonly taken as referring to an actual change in asset strategy to manage the assets closer to the liabilities.
- **London Interbank Offer Rate (LIBOR)** is the interest rate banks charge each other for short term lending. It is often used as a measure of a cash return when setting benchmarks.
- **Long** in terms of investing is where the stock is bought, and therefore the manager is assuming that the stock price will rise.
- **Market capitalisation** is the total value of all the shares currently in issue in a company.
- **Passive management** is where the manager aims to track an index return by holding the entire index.
- **Price / earnings ratio** is defined as the ratio of a company's current share price compared to its per-share earnings. Currently the average P/E ratio of the stocks in the FTSE All-Share is around 18.

$$\text{P/E Ratio} = \frac{\text{Share Price}}{\text{Earings per Share (EPS)}}$$

- **Quantitative investing** is where all portfolio decisions are automated. A computer programme is used to select the stocks in the portfolio by analysing data relating to the stocks and applying a set of rules. The role of the portfolio manager is to set up the rules and other parts of the system when the process begins and then to monitor it going forward.
- **Regret risk** is the risk of taking actions that differ from the starting position or the accepted norm.

Glossary

- **Tracking error** is a measure of the volatility of relative performance. It is calculated as the standard deviation of the difference between the performance of the portfolio and the performance of the benchmark. Tracking error is often used to measure how much active risk is being taken in a portfolio. Generally, the more active risk a manager takes, the more volatile the relative performance. As an example, an equity portfolio with an outperformance objective of 1% would normally have a tracking error in the range 2-4%.
- **Value stock:** A fund manager will describe a stock as a ‘value stock’ if they believe that the current market price is less than the stock’s intrinsic value. This can occur due to negative market sentiment. A value stock usually has a low PE ratio, a high yield and a low price to book value (NAV). When investing in value stocks the fund manager is making a call that the market’s negative view is incorrect. A manager who tries to outperform the benchmark by correctly identifying value stocks is said to have a ‘value style’ or ‘value bias.’

Disclaimer

This document and any enclosures or attachments are prepared on the understanding that it is solely for the benefit of the addressee(s). Unless we provide express prior written consent, no part of this document should be reproduced, distributed or communicated to anyone else and, in providing this document, we do not accept or assume any responsibility for any other purpose or to anyone other than the addressee(s) of this document.

Notwithstanding the level of skill and care used in conducting due diligence into any organisation that is the subject of a rating in this document, it is not always possible to detect the negligence, fraud, or other misconduct of the organisation being assessed or any weaknesses in that organisation's systems and controls or operations.

This document and any due diligence conducted is based upon information available to us at the date of this document and takes no account of subsequent developments. In preparing this document we may have relied upon data supplied to us by third parties (including those that are the subject of due diligence) and therefore no warranty or guarantee of accuracy or completeness is provided. We cannot be held accountable for any error, omission or misrepresentation of any data provided to us by third parties (including those that are the subject of due diligence). This document is not intended by us to form a basis of any decision by any third party to do or omit to do anything.

Any opinions or assumptions in this document have been derived by us through a blend of economic theory, historical analysis and/or other sources. Any opinion or assumption may contain elements of subjective judgement and are not intended to imply, nor should be interpreted as conveying, any form of guarantee or assurance by us of any future performance. Views are derived from our research process and it should be noted in particular that we can not research legal, regulatory, administrative or accounting procedures and accordingly make no warranty and accept no responsibility for consequences arising from relying on this document in this regard.

Calculations may be derived from our proprietary models in use at that time. Models may be based on historical analysis of data and other methodologies and we may have incorporated their subjective judgement to complement such data as is available. It should be noted that models may change over time and they should not be relied upon to capture future uncertainty or events.

This page is intentionally left blank

REPORT FOR: Pension Fund Committee

Date of Meeting:	25th June 2013
Subject:	Infrastructure and Local Investing
Responsible Officer:	Simon George, Director of Finance and Assurance
Exempt:	No
Enclosures:	.Aon Hewitt Report

Section 1 – Summary and Recommendations

Infrastructure and local / impact investing are topical issues and offer the potential for greater diversification of the investment portfolio and some positive local benefit from investing. There are many challenges and the proposal is that a watching brief is maintained for developed proposals in particular the Pension Infrastructure Platform.

Recommendation:

The Panel is invited to agree to monitor future opportunities.

Section 2 – Report

1. This note and the attached Aon Hewitt report address two topical issues – infrastructure and local / impact investing. These were highlighted at the last meeting as ‘new opportunities’ worthy of a brief discussion.

2. Should the Committee be interested in further developing the issues, a more detailed paper will be developed.

Infrastructure

3. The definition of infrastructure is imprecise but tends to relate to investments that derive their income from the use of physical assets, such as a rental charge. Examples include water utilities, energy and communication transmission, transport facilities (ports, airports, roads and bridges) etc. PFI contracts in which Government pays for use of a hospital or school are also examples. Classic characteristics are a usage related fee, barriers to entry through the costs of developing the assets, potentially fees set by a regulator, inflation linked income and long contracts etc.

4. The characteristics of infrastructure appear ideal for pension schemes, in particular the inflation linked long term income streams and these types of assets are often seen as an alternative to index linked bonds as matching scheme liabilities. Investor interest with infrastructure projects has soared since 2000 with sovereign wealth funds joining pension and insurance funds and many opportunities are already held in specialist funds, somewhat diminishing the attractiveness of the sector.

5. Investments to date have mainly been in large global funds that buy existing in-use assets. Pension schemes have as a whole avoided the risk of investing in new build assets. In particular, the uncertainties of construction cost and the future revenue that will be generated all make new build less appealing than existing assets. Examples of new build investments that incurred a loss include the Channel tunnel (construction cost over-runs) and the M6 toll road (low usage). When Government encourage investment in infrastructure, it tends to be in new build, which is the segment of the market that pension funds have avoided.

6. One response to the Government’s wish to see more pension fund investment in infrastructure, is the Pension Infrastructure Platform (PIP) jointly led by the National Association for Pension Funds and Pension Protection Fund, that aims to raise a fund of £2bn to invest in “core infrastructure, and in projects free of construction risk and on an availability basis so as to avoid excessive GDP [usage] risk. Investments will be inflation-linked and the fund is seeking long-term cash returns of RPI +2% to 5%.” Although initially the fund is seeking large ‘founder’ schemes to commit £100 million each, it is planned to open to all schemes. However, the start date has been delayed as details of the proposed government guarantee to protect against construction and usage risk await finalisation.

7. PIP and other similar projects being discussed do offer the possibility of interesting opportunities. It is suggested that if the Committee is primarily interested in UK rather than global infrastructure, that it monitors the

initiatives currently underway rather than investigate the traditional infrastructure fund space.

Local / Impact Investing

8. A potentially much more challenging area is investments that target the local community or possibly help to address Council priorities, while at the same time meeting the income needs of the fund. The term growth investment is also used to highlight the aim of delivering a positive local economic impact.

9. What this actually means in practice is somewhat vague as few examples, even those on the drawing board, exist. In recent months the following initiates have appeared in the press:

   a) Manchester Council and their pension fund are planning to build mixed use housing on land owned by the Council.

   b) Five large Councils in Yorkshire, Merseyside and Manchester have agreed to jointly contribute £250 million to an ‘investing for growth initiative’. They are seeking expressions of interest from asset managers. A wide range of investments will be considered and will include those with beneficial social, economic and environmental impact and could include infrastructure, resource management and business development projects.

   c) Strathclyde pension has hired an investment manager to lead a greater focus on local investing.

10. Other than the first example involving housing, no actual investments are known. Harrow’s housing team has been examining opportunities for construction of social or affordable housing and a pension fund involvement is one funding opportunity being considered.

11. For these types of opportunities to work, they must meet most of the following conditions:

    - An expectation of market or close to market returns,
    - Some guarantee or mitigation of risk while approaching market level returns,
    - Liquidity which helps reduce perceived risk,
    - Robust measurement and evidence of the returns generated by the investment,
    - Larger sized investment opportunities, for example pooled funds, and
    - Fund managers with a track record.

12. It is suggested that the only realistic approach is in tandem with other London boroughs and involving skilled investment managers. If the panel is interested and wishes to act now the suggested steps are:

    a) Develop an objective on the lines of 9 (b) above,
    b) Identify a Harrow commitment level and a minimum collective fund size,
    c) Approach other London boroughs seeking partners, and

d) Depending on the level of interest determine if the project is deliverable.

13. Harrow is not resourced to drive such a project and we would need support, potentially incurring project feasibility costs. Alternatively, the Committee can monitor opportunities and express interest if suitable ones arise. In reality, this is probably the better approach.

Financial Implications

14. Widening the scope of investments offers the possibility of greater diversification and higher returns. Including non financial factors in the decision making may compromise the long term funding level.

Risk Management Implications

15. Risk included on Directorate risk register? No

16. Separate risk register in place? No

17. Setting risk tolerances and measuring outcomes is central to the strategy.

Equalities implications

18. Was an Equality Impact Assessment carried out? Yes

19. There are no direct equalities implications relating to the pension fund.

Corporate Priorities

20. Corporate Priorities are not applicable to the Pension Fund as it does not have a direct impact on Council resources.

Legal Implications

21. The report has been reviewed by Legal Department and comments received are incorporated into the report.

Section 3 - Statutory Officer Clearance

Name: Simon George Date: 10 June 2013	√	Chief Financial Officer
Name: Matthew Adams Date: 10 June 2013	√	Monitoring Officer

Section 4 - Contact Details and Background Papers

Contact: George Bruce (Treasury and Pension Fund Manager) Tel: 020-8424-1170 / Email: george.bruce@harrow.gov.uk

Background Papers: Papers and training material provided to the PFIP meetings on 12 October 2011, 15 November 2011 and 25 June 2012 and 27 November 2012.

If appropriate, does the report include the following considerations?

1.	Consultation	N/A
2.	Corporate Priorities	N/A

This page is intentionally left blank

A discussion paper for the London Borough of Harrow

Date: 10 June 2013
Prepared for: The Pensions Committee
Prepared by: Tony Baily

Infrastructure as an asset class

Introduction

The London Borough of Harrow Pension Fund (the Fund) has decided to look in to one alternative asset class at each pensions committee meeting. The first of these asset classes, infrastructure, will be discussed at the meeting on 25 June 2013. This paper addresses the characteristics of infrastructure investment, how it can be accessed and whether local investment is a viable option.

Executive Summary

- Historically, the vast majority of global infrastructure has been funded with public capital. It was not until relatively recently that institutional investors began including infrastructure as an asset class either on a stand-alone basis or as part of their allocation to other real assets. Unlisted infrastructure funds have raised c.£216bn from institutional investments since 2005.
- We expect trends such as deleveraging by corporates and banks, government privatisations and policies to promote infrastructure development to create a healthy pipeline of infrastructure assets globally.
- Infrastructure is not a homogenous asset class. There is significant variation in the types of infrastructure assets and manager strategies.
- Key differentiating characteristics include source of revenue (availability, demand), lifecycle stage (brownfield, greenfield), sector (transport, utilities, communication), geography (regional, global) and position in capital structure (debt, equity).
- Depending on the strategy, returns can vary from low single digits to high double digits plus.
- The infrastructure opportunity can be accessed in a number of ways, including: unlisted funds (closed and open-ended), listed infrastructure, secondary market opportunities, Fund of funds, customised managed accounts, co-investment and direct investment.

Characteristics of infrastructure investments

Historically, the vast majority of global infrastructure has been funded with public capital. Towards the end of the 20th century, however, governments began to sell off infrastructure assets, either permanently or for specified lease periods, to private bidders in order to fund their budget deficits. The 1980s and 1990s saw the onset of privatisation and Public Private Partnership ('PPP') projects. The creation of infrastructure specific partnerships aimed at institutional investors was not prevalent in the marketplace until the early 2000's.

Consulting | Investment Consulting Practice
10 Devonshire Square | London EC2M 4YP
t +44 (0) 20 7086 8000 | f +44 (0) 20 7086 1878 | aonhewitt.co.uk
Aon Hewitt Limited | Registered in England & Wales No. 4396810 | Registered office: 8 Devonshire Square London EC2M 4PL
Authorised and regulated by the Financial Conduct Authority.

There is no universally accepted definition of what constitutes an infrastructure investment, but most agree that is should exhibit some or all of the following characteristics:

- Provision of essential services
- Strong market position with high barriers to entry
- Sustainable, stable long term cash flows, underpinned by regulation or long-term contracts
- Explicit or implicit inflation correlated revenues and pricing
- Low correlation to other asset classes

There is significant variation across the infrastructure asset class. Some key differentiating characteristics include:

- Source of revenue
- Lifecycle stage
- Sector
- Geography
- Position in capital structure

These are each discussed in turn below. Depending on the type of asset, the risk and return profile can differ considerably.

Source of revenue

Infrastructure assets typically derive revenue either from a government backed long-term concession arrangement ('social' infrastructure) or directly from end users ('economic' infrastructure).

Lifecycle stage

The risk and return profile of the same asset can vary substantially depending on whether an investment is made before or during ('greenfield') or after ('brownfield') the development and construction stage.

Sector

Infrastructure investment covers a range of sectors, including:

- Transportation – includes toll roads, bridges, tunnels, parking facilities, railroads, rapid transit links, airports, refuelling facilities, and seaports.
- Utilities – includes electricity transmission, electricity generation, gas, water distribution, sewage treatment. Renewable energy assets such as wind, solar and hydro generation can also be included in this category.
- Communication – includes broadcast and wireless towers, telecommunications, cable networks and networks.
- Social – includes courthouses, hospitals, schools, prisons, stadiums, and social housing.

Each sector can differ materially in terms of market dynamics, types of user, cash flow and the risk/return profile.

Geography

Returns from infrastructure assets and the risks that need to be considered vary considerably depending on the country or region. Differentiating factors include macroeconomic conditions, regulatory regimes, political stability, counterparty credit ratings, capital markets, natural resource availability and other country specific factors. Currency risk also needs to be considered.

Position in capital structure

Another key source of variation that affects the risk/return profile relates to where the investment sits within the capital structure of the business or project. Equity sits higher in the capital structure and takes first loss above debt. Equity is therefore higher risk but investors also expect a higher return potential.

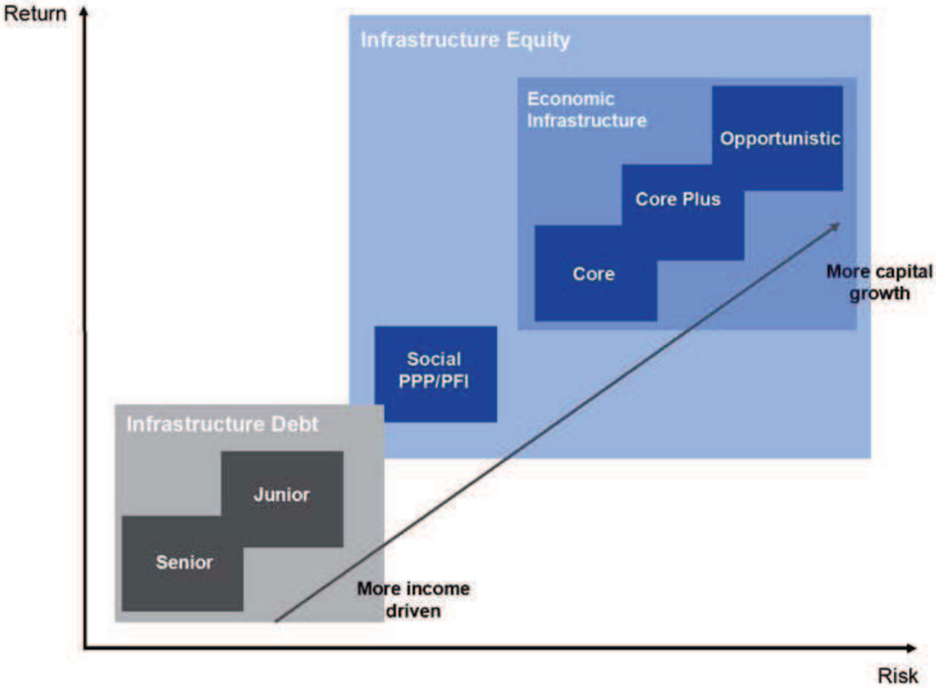
Below are two charts that summarise the types of infrastructure investment available (Chart 1) and their risk return profile (Chart 2).

Chart 1: Infrastructure is not a homogenous asset class

	Social (PFI/PPP)	Economic		
	Availability	Regulatory	Demand based	Market
Revenue Source	▪ Government backed concession	▪ End users	▪ End users	▪ End users
Investment risks (incremental)	▪ Operating costs ▪ Delivery (service performance) ▪ Political	+Regulatory risk +Volume risk (generally low)	+Volume risk (e.g. traffic) +Some pricing risk (generally low)	+ Competitive and pricing risks + Commodity risks
Examples	▪ Hospitals, schools, government accommodation ▪ Sports stadia ▪ Availability based transport	▪ Energy distribution and transmission ▪ Water, waste water ▪ Renewable energy	▪ Tolled roads, tunnels, bridges ▪ Rail ▪ Airports ▪ Seaports ▪ Pipelines	▪ Merchant power (no off-take) ▪ Service stations ▪ Car parks ▪ Waste / waste to energy

Risk Low — High

Chart 2: The infrastructure risk/return spectrum



Accessing Infrastructure investment

The infrastructure opportunity can be accessed in a number of ways, including:

- Unlisted funds (closed and open-ended)
- Listed infrastructure
- Secondary market opportunities
- Fund of funds
- Customised managed accounts
- Co-investment
- Direct investment

We have assumed that the Fund will be unlikely to invest more than 30% in infrastructure and so will be limited to c. £160m. This amount is not large enough to invest directly and unless the maximum was invested co-investment and customised managed accounts are unlikely to be an option. Therefore we have concentrated on the other four options below.

Unlisted funds (closed and open-ended)

Unlisted funds are pooled vehicles generally structured as limited partnerships. Such vehicles have been prevalent in the private equity space for many years. LGPS regulations have recently been amended to increase the maximum that can be invested in limited partnerships from 15% to 30%. The driving force behind the increase was to enable the LGPS more flexibility to invest in infrastructure.

Closed-ended unlisted infrastructure funds have historically been the preferred vehicle for accessing the asset class. Investors make capital commitments that are drawn down over a period of three to five years as the manager sources and executes appropriate investment opportunities. Distributions are then returned to investors over the life of the fund (which can be anything from 10 to 50 years depending on the strategy).

There are a small number of open-ended unlisted infrastructure funds in the market. These funds buy assets and then hold them for the long-term. Open-ended structures have the advantage over their closed-ended counterparts of offering liquidity to their limited partners, although some funds have lock-up arrangements as well as exit penalties and managers typically eschew investors who are short term driven.

Listed infrastructure

Many infrastructure assets and companies are listed on global stock exchanges. However, we generally prefer access through closed ended limited private-equity style partnership vehicles as described above. We believe that a number of potential opportunities will generally not be available in the listed market, that there is a clear diversification benefit with privately held equity and far more opportunities for managers to add value. Long-term investors should also benefit from an expected illiquidity premium.

However, there are occasions when accessing infrastructure through the listed markets may be more appropriate for some investors. For example those that have clear liquidity needs or are prohibited in some way from investing in unlisted funds.

Secondary market opportunities

Although not a well developed market, it is possible to purchase interests in established limited partnerships from existing limited partners looking to exit their investment. The secondary buyer purchases the interests from the seller at a negotiated price and typically assumes any unfunded obligation of the seller. Investors can reduce uncertainty by participating in secondary investments as many of the underlying investments are already known. Secondary transaction discounts fluctuate widely and the availability of specific fund interests are unpredictable and may be difficult to access. Furthermore, pricing a secondary transaction is complex and laborious and an investor is likely to require external expertise and resource to do this with confidence.

Fund of funds

Fund of funds can offer a more diversified exposure than might otherwise be achievable, particularly for smaller investors. They also offer access to primary, secondary, co-investment and direct opportunities through a single wrapper.

However, there is a double layer of fees to consider and among the few products available portfolios tend be tilted toward the higher risk end of the spectrum as fund of fund managers need to outperform their own return hurdles before earning performance fees. In addition, the relatively small size of the underlying funds universe can make it difficult to construct a high quality fund of funds portfolio.

We do not generally recommend a fund of funds approach.

Local infrastructure investment

Local councils commonly express an interest in local infrastructure to try and utilise the pension scheme assets for the good of the community. This would have the benefit of giving something back to the local council taxpayers who fund the deficit. However others argue that investing in local infrastructure is not a viable option for the following reasons:

Conflicts of interest

The infrastructure projects that the Fund would be investing in would be run by the Council. This potentially creates a conflict of interest since the Council will aim to obtain the best terms for the investment eg by receiving a higher investment or paying a lower fee whereas the Fund will want to maximise the return on their investment. In this case the Council would be negotiating with itself.

An additional conflict may be created in that one of the Fund's objectives is to maximise the returns that they receive in order to recover the deficit and reduce the impact on council tax. They therefore should be looking to investments that give them the best risk return trade offs not just those that are based in a certain location.

Diversification

Investing in just one area creates a lack of diversification since all the investment is concentrated in one small area. The fact that this area is also the location of all the Council Tax payers reduces the diversification even further. For example, if the investment were in a car park then the return on investment would come from the users, probably the residents of the borough. If the average income fell then there would be less people driving and so using the car park. This would reduce the return on the infrastructure investment. The resulting deficit in the Fund would need to be made up by council tax payers however there would be less of these since the average income has fallen.

With the amount of cash that the Fund would have to invest c.£160m max, only one or two investments would be possible. This would create a lack of diversification by project type.

Funds needed

If the Fund were to invest locally then it would need to either invest directly or try to find a manager to invest on its behalf. The minimum needed to invest directly in infrastructure would be £500m-£1,000m. Therefore this is not a viable option. Finding a manager who would solely invest in one area and raising funds from other investors would also be very difficult. This can be seen in the fact that the Pensions Infrastructure Platform has been looking to set up a fund for the last year and details on the investment strategy or how the fund will be managed have not yet been released.

Other options

One way could be to invest in a European infrastructure fund that has or plans to have investments in London so that there is an element of localism within the asset class.

Current opportunities

We believe there are a number of factors that continue to support and expand the infrastructure investment opportunity:

- Historically there has been **underinvestment** in the maintenance and development of infrastructure across developed economies. Booz Allen estimates that $41 trillion will be required globally in the next 25 years with €9.1 trillion required in Europe by 2030.
- We expect to see most of the compelling opportunities in the **developed markets**. Although economic growth and urbanisation will require a substantial build out of infrastructure in emerging markets, we expect this infrastructure to be of a much higher risk profile than core infrastructure in developed markets.
- The corporate world is moving to **lower levels of leverage**. This is leading to opportunities as companies **re-focus on core businesses** through the unbundling and disposal of non-core assets. Examples are the disposal of Finland's transmission grid by Vattenfall and the sale of the Open Grid Europe gas network by E.On.
- Regulators and policymakers around the world continue to adopt more favourable frameworks to encourage and promote participation and **competition** among private investors. The unbundling of non-core energy assets due to EU directives and forced airport divestments by BAA in the UK are examples. New regulation such as Basel III could force further disposals of investments held on bank balance sheets and limit their ability to participate in new opportunities.
- **High government debt levels** are also encouraging the sale of core infrastructure assets through privatisations. An example is the privatisation of certain French regional airports. However, the pace of privatisations has generally been slower than anticipated.
- With growth at low levels for most developed economies, governments need to **boost economic activity** and are increasingly looking at infrastructure to provide that boost. The UK government, for example, has been calling on institutional investors to increase investment in infrastructure.
- Discovery of **shale resources** globally, especially in the US, will require a significant infrastructure build out. We expect a number of midstream opportunities such as pipelines and storage facilities to come to market.
- Although there have been a significant number of energy related opportunities, other parts of the market in the US such as transportation and social infrastructure have been slow to evolve. However, over 30 states now have **PPP legislation** and we have seen steady growth over the last 5 years.
- There will be an increasing level of **funds looking to exit** portfolios. This will be driven by infrastructure managers that raised capital in the early to mid 2000s that will soon be looking to sell some of their portfolio companies as they near the end of their investment terms.
- **Financing terms** for infrastructure assets are currently very attractive due to low LIBOR rates and a good level of liquidity in the markets.

Pensions infrastructure platform (PIP)

The PIP is an infrastructure fund being developed and sponsored by the National Association of Pension Funds ('NAPF') and the Pension Protection Fund ('PPF') along with an expected 10 – 12 founding UK pension funds. It is being put forward as a solution 'for pension plans by pension plans' and follows on from the Memorandum of Understanding signed by two groups of pension funds (one being the NAPF/PPF led group) with the UK Government to support additional infrastructure investment.

The NAPF/PPF are currently in discussion with a group of larger UK pension plans interested in participating as founding investors. As well as investing directly in the fund itself, the founding investors will also own the management platform and have responsibility for developing the PIP into a full fund offering. The founding investors are expected to make an initial investment of £100-250k each to cover establishment costs, with minimum commitments of £100m to be invested in the fund once it is ready to be launched. The PIP is targeting commitments of £2bn, with broadly £1bn from the founding investors and £1bn from later stage investors. Minimum investment levels for later stage investors will be substantially below the £100m threshold set for founding investors.

The PIP has 10 founding investors to date with Lloyds TSB and the London Pension Fund Authority being the most recent additions.

We are yet to receive clarity on how the PIP will be managed, viz-a-viz recruiting an in-house team vs. an externally managed vehicle. We also await more details on the investment strategy it will pursue. Notwithstanding this, there are clear potential benefits of a solution 'for pension funds by pension funds'. Management fees are one area where we expect to see such benefits (even though infrastructure managers are increasingly competitive here).

We believe that this could develop into a credible opportunity for clients looking to gain exposure to the infrastructure asset class. We understand that a 2013 launch date is targeted for the PIP. We will continue to monitor the development of the platform and will look to undertake a comprehensive due diligence and rating exercise in due course including a full appraisal against market peers.

Next steps

- Discuss the asset class at the 25 June Pensions Committee meeting
- If investment in the asset class is desired then Aon Hewitt can provide further details or additional training

---

Signed on behalf of Aon Hewitt Limited

Tony Baily FIA
Partner
+44 (0)20 7086 9011
tony.baily@aonhewitt.com

Disclaimer

This document and any enclosures or attachments are prepared on the understanding that it is solely for the benefit of the addressee(s). Unless we provide express prior written consent, no part of this document should be reproduced, distributed or communicated to anyone else and, in providing this document, we do not accept or assume any responsibility for any other purpose or to anyone other than the addressee(s) of this document.

Notwithstanding the level of skill and care used in conducting due diligence into any organisation that is the subject of a rating in this document, it is not always possible to detect the negligence, fraud, or other misconduct of the organisation being assessed or any weaknesses in that organisation's systems and controls or operations.

This document and any due diligence conducted is based upon information available to us at the date of this document and takes no account of subsequent developments. In preparing this document we may have relied upon data supplied to us by third parties (including those that are the subject of due diligence) and therefore no warranty or guarantee of accuracy or completeness is provided. We cannot be held accountable for any error, omission or misrepresentation of any data provided to us by third parties (including those that are the subject of due diligence). This document is not intended by us to form a basis of any decision by any third party to do or omit to do anything.

Any opinions or assumptions in this document have been derived by us through a blend of economic theory, historical analysis and/or other sources. Any opinion or assumption may contain elements of subjective judgement and are not intended to imply, nor should be interpreted as conveying, any form of guarantee or assurance by us of any future performance. Views are derived from our research process and it should be noted in particular that we can not research legal, regulatory, administrative or accounting procedures and accordingly make no warranty and accept no responsibility for consequences arising from relying on this document in this regard.

Calculations may be derived from our proprietary models in use at that time. Models may be based on historical analysis of data and other methodologies and we may have incorporated their subjective judgement to complement such data as is available. It should be noted that models may change over time and they should not be relied upon to capture future uncertainty or events.

This page is intentionally left blank

REPORT FOR: Pension Fund Committee

Date of Meeting:	25th June 2013
Subject:	External Audit Plan 2012-13
Responsible Officer:	Simon George, Director of Finance and Assurance
Exempt:	No.
Enclosures:	.Deloitte's Audit Plan

Section 1 – Summary and Recommendations

.
Deloitte will undertake an audit of the pension fund's financial statements. Attached is their audit plan. There are no significant changes from the prior year. The plan has been presented to GARM Committee.

Recommendation:

The Panel is invited to note the audit plan.

Harrow COUNCIL LONDON

Section 2 – Report

1. The pension fund is required to prepare financial statements for the year to 31st March 2013. These will be audited by Deloitte, whose audit plan is attached.

2. The plan has no significant changes from the prior year. The key audit risks are identified as contributions, benefits, private equity, derivatives and management overriding controls. Materiality is set at £4.8 million (prior years £5.3 million) although all unadjusted errors above £242,000 (PY £260,000) will be reported.

3. The audit fee is substantially reduced to £21,000 (PY £35,000) arising from changes to the way the Audit Commission is funded. Deloitte's remuneration is unchanged. The partner and senior manager continue from 2012.

4. The plan has been presented to GARM Committee at which no significant comments arose.

5. It is anticipated that the accounts will be completed by end of June 2013 and the audit report issued in August. Both will be presented to the Committee at the September meeting.

Financial Implications

6. None.

Risk Management Implications

7. Risk included on Directorate risk register? No

8. Separate risk register in place? No

9. Setting risk tolerances and measuring outcomes is central to the strategy.

Equalities implications

10. Was an Equality Impact Assessment carried out? Yes

11. There are no direct equalities implications relating to the pension fund.

Corporate Priorities

12. Corporate Priorities are not applicable to the Pension Fund as it does not have a direct impact on Council resources.

Legal Implications

13. The report has been reviewed by Legal Department and comments received are incorporated into the report.

Section 3 - Statutory Officer Clearance

Name: Simon George Date: 10 June 2013	√	Chief Financial Officer
Name: Matthew Adams Date: 10 June 2013	√	Monitoring Officer

Section 4 - Contact Details and Background Papers

Contact: George Bruce (Treasury and Pension Fund Manager) Tel: 020-8424-1170 / Email: george.bruce@harrow.gov.uk

Background Papers: None.

If appropriate, does the report include the following considerations?

1.	Consultation	N/A
2.	Corporate Priorities	N/A

This page is intentionally left blank

Deloitte.

London Borough of Harrow Council

Report to the Governance, Audit and Risk Management Committee

Audit Plan for the Pension Fund Audit year ending 31 March 2013

March 2013

Deloitte.

Governance, Audit and Risk Management Committee
Harrow Council
Station Road
Harrow
HA1 2XY

19 March 2013

Dear Sirs

We have pleasure in setting out in this document our planning report to the Governance, Audit and Risk Management Committee of London Borough of Harrow Council for the year ended 31 March 2013, for discussion at the meeting scheduled for 6 April 2013. This report covers the principal matters that we will focus on during our audit for the year ended 31 March 2013.
In summary:

- The major issues, which are summarised in the Executive Summary, and how we plan to address them.
- The scope of our work follows that of previous years

We would like to take this opportunity to thank George Bruce and his team for their assistance and co-operation during the planning of our audit work.

Paul Schofield

Senior Statutory Auditor

Contents

Executive summary

Status	Description	Detail
Audit scope		
Audit scope is unchanged from previous years	Based on guidance issued by the Audit Commission, auditors are again asked, for audit purposes, to treat the Local Government Pension Fund (LGPS) as a stand-alone body, with separate audit plan and reports to those charged with governance. Our audit of the pension fund is planned in accordance with the Code of Audit Practice issued by the Audit Commission and in accordance with additional guidance issued by the Commission in relation to the audit of pension funds. However, this only extends to the audit of the accounts and there is no requirement for a value for money conclusion on the pension fund accounts specifically. Aspects of the use of resources framework will inform the value for money conclusion for the Authority and cover issues relating to the pension fund. The pension fund accounts remain part of the accounts of the Authority as a whole. The LGPS Regulations require administering authorities to prepare an annual report for the pension fund, which should incorporate the annual accounts. Our audit report on the Authority accounts will continue to cover the pension fund section of that document. In addition, we are asked by the Commission to issue an audit report for inclusion in the annual pension fund report.	Section 1
Materiality		
Materiality is limited by that of the authority	We calculate materiality on the basis of the net assets of the fund, but have restricted this to the materiality established for the audit of the Authority's financial statements as a whole. We estimate materiality for the year to be £4.8 million (2012: £6.3 million). We will report to the Governance, Audit and Risk Management Committee on all unadjusted misstatements greater than £242,000 (2012: £300,000). We will update our assessment when the year end results become available. Further details on the basis used for the calculation of materiality are given in our audit plan for the audit of the Authority's financial statements.	

Executive summary (continued)

Status	Description	Detail
Key audit risks		
Audit risks focus on contributions, benefits and investments	The key audit risks which we have identified as part of our overall audit strategy are: 1. In view of the complexity arising from the participation of different admitted bodies within the fund, together with the fact that members may pay different rates depending on their pensionable pay, we have included the calculation and payment of contributions as areas of audit risk. 2. As there are a number of complexities to the calculation of both benefits in retirement and ill health and death benefits, we have identified benefits payable as an area of specific risk. 3. The pension fund is invested in unquoted investment vehicles such as the Pantheon private equity fund and the Aviva property fund. The fund is also invested in derivative financial instruments with Record. Such investments can give rise to complexities in accounting, disclosure and measurement; accordingly we will treat the appropriateness of the accounting and disclosure of these investments as a risk. 4. Auditing standards (ISA 240) require auditors to consider management override of controls to be a presumed area of risk for all audit engagements.	Section 2
Other issues		
Changes to the bank account process	Whilst not considered to be a significant audit risk we note that the authority is now using a separate bank account for the pension fund. We set out our response to this in section3	Section 3
Prior year uncorrected misstatements including disclosure misstatements		
No uncorrected misstatements identified in the prior year	There were no significant unadjusted misstatements or uncorrected disclosure deficiencies reported to you in respect of the 2011/12 accounts	

Executive summary (continued)

Status	Description	Detail
Timetable		
Timetable is in line with prior year	The timetable is set out in Section 5. The fieldwork will be carried out at the same time as our work on the Authority's financial statements. We plan to finalise our audit report included within the Pension Fund Annual Report at the same time as that included in the Authority's accounts.	Section 5
Independence		
We confirm our independence	Deloitte have developed important safeguards and procedures in order to ensure our independence and objectivity. These are set out in the "Independence policies and procedures" section included in our briefing on audit matters. We will reconfirm our independence and objectivity to the Governance, Audit and Risk Management Committee for the year ending 31 March 2013 in our final report. We have discussed our relationships with the Authority in our separate audit plan for the audit of the Authority's financial statements.	
Fees		
Our fee is in line with the Audit Commission scale	Our fee for the audit of the pension fund for the year ending 31 March 2013 is £21,000. The 2012-13 scale fees that the Audit Commission has set include reductions of up to 40% on 2011-12 fees. These result from savings generated from the outsourcing of the Audit Commission's in-house Audit Practice and internal efficiency savings that the Commission is passing on to audited bodies. Under our new arrangements with the Audit Commission, Deloitte's net re-imbursement for external services provided remains unchanged from those previously agreed. The scale fee reductions do not therefore have an impact on our ability to continue offering a high quality service to you.	
Matters for those charged with governance		
Briefing on audit matters	We have included in Appendix 1 our "Briefing on audit matters" which includes those additional items which we are required to report upon in accordance with International Standards on Auditing (UK & Ireland). We will report to you at the final audit stage any matters arising in relation to those requirements.	Appendix 1
Engagement team		
Paul Schofield will lead the audit	Paul Schofield will lead the audit and will be supported by David Hobson as Senior Manager and David Boyd who will be the day to day contacts on the engagement.	

1. Scope of work and approach

Overall scope and approach

Based on guidance issued by the Audit Commission, auditors are again asked, for audit purposes, to treat the Local Government Pension Fund (LGPS) as a stand-alone body, with separate audit plan and reports to those charged with governance.

Local LGPS funds administered by administering authorities are not statutory bodies in their own right. Therefore, it is not possible for separate audit appointments to be made for LGPS audits. We are therefore appointed to the audit of the LGPS through the existing Audit Commission appointment arrangements.

Our audit of the pension fund is planned in accordance with the Code of Audit Practice issued by the Audit Commission and in accordance with additional guidance issued by the Commission in relation to the audit of pension funds. However, this only extends to the audit of the accounts and there is no requirement for a value for money conclusion on the pension fund accounts specifically. Aspects of the use of resources framework will inform the value for money conclusion for the Authority and cover issues relating to the pension fund.

The audit opinion we intend to issue as part of our audit report on the Authority's financial statements will reflect the financial reporting framework adopted by the pension fund. This is the CIPFA/LASAAC Code of Practice 2012/2013 on Local Authority Accounting in the United Kingdom (the "Code of Practice").

For pension fund statements, we have initially considered the net assets of the fund as the benchmark for our materiality assessment as this benchmark is deemed to be a key driver of business value, is a critical component of the financial statements and is a focus for users of those statements. However, we have restricted our estimate of materiality to the amount set for the Authority's financial statements as a whole, which is £4.8 million. Our separate audit plan for the audit of the Authority's financial statements includes further information on how we derived this estimate. The concept of materiality and its application to the audit approach are set out in our Briefing on audit matters document.

The extent of our procedures is not based on materiality alone but also on the quality of systems and controls in preventing material misstatement in the financial statements, and the level at which known and likely misstatements are tolerated by you in the preparation of the financial statements.

1. Scope of work and approach (continued)

The Audit Commission has also determined that auditors should give an opinion in accordance with auditing standards on the financial statements included in the pension fund annual report. This entails the following additional work over and above giving an opinion on the pension fund accounts included in the statement of accounts:

- comparing the accounts to be included in the pension fund annual report with those included in the statement of accounts;
- reading the other information published within the pension fund annual report for consistency with the pension fund accounts; and
- where the pension fund annual report is not available until after the auditor reports on the financial statements, undertaking appropriate procedures to confirm that there are no material post-balance sheet events arising after giving the opinion on the pension fund accounts included in the financial statements.

The financial statements included in the pension fund annual report are prepared on the basis of the same proper practices - the Code of Practice - as the financial statements included in the statement of accounts.

2. Significant audit risks

Based upon our initial assessment and following discussion with management, we will concentrate specific effort on the significant audit risks set out below.

Contributions		Deloitte response
Tiered contribution rates increases complexity	Unlike the position in the private sector, we are not required to issue a statement about contributions in respect of the LGPS. However, this remains a material income stream for the pension fund and in view of the complexity introduced by the participation of more than one employer in the fund, and a structure with tiered contribution rates, we have identified these areas as specific risks.	We will perform the following procedures to ascertain whether employer and employee contributions have been calculated, scheduled and paid in accordance with the schedule: • Review the design and confirm the implementation of key controls present at the Fund for ensuring contributions from all Scheduled and Admitted bodies identified and calculated correctly. • Recalculate contributions for a sample of individual members to ensure that they are calculated in accordance with the schedule of rates. • Perform analytical review procedures to gain assurance over the total contributions received in the year. • Reconcile the membership movements in the year to the Financial Statements, ensuring that these include members from the admitted bodies. We note that the authority is not responsible for the calculation of contributions and will therefore perform such tests with the assistance of the other scheduled and admitted bodies.

2. Significant audit risks (continued)

Benefits		Deloitte response
There are a number of complexities to the calculation of both benefits in retirement and ill health and death benefits	The complexities surrounding the calculation of both benefits in retirement and ill health and death benefits remains a key area of audit risk. In respect of benefits in retirement, benefits are accumulated on two different bases for service pre and post 1 April 2008; the calculation of the pensionable pay on which benefits will depend may be varied by the individual opting to take account of pay earned in any of the 10 years prior to retirement; and individuals now enjoy greater flexibility in their choice of the mix of pension and lump sum. In respect of ill health and death benefits, the calculation of the pensionable pay on which benefits will depend may be varied by the same options as discussed above. The completion of the legislation leading to the change in the revaluation basis to Consumer Price Index added further complexity to the above calculations.	We will perform the following procedures to ensure that the benefits payable have been calculated correctly in accordance with the fund rules. • Review the design and confirm the implementation of key controls present at the Fund for ensuring benefits are calculated correctly. • Recalculate a sample of benefit calculations made in the year • Perform analytical review procedures to gain assurance over the total pensions paid figure in the year.

2. Significant audit risks (continued)

Financial instruments		Deloitte response
The fund is invested in some non-quoted investment vehicles	The majority (70%) of the portfolio is invested in pooled equity investments, these are typically easy to value as it is possible to obtain independently quoted values. The fund also invests in non-quoted investment vehicles, such as the Pantheon private equity investments and the Aviva property fund of funds. Private equity funds and property fund of funds are complex to value and include an element of judgement on the part of the investment manager. Given that these funds form a material balance within the pension fund accounts, we have identified the valuation of these funds as a specific risk. The fund also makes use of derivatives which can be complex in terms of accounting, measurement and disclosure requirements.	For the private equity funds and property fund of funds we will seek to understand the approach adopted in the valuation of such investments and inspect documentation such as cash flow reports, quarterly investment advisor reports and audited financial statements. We will tailor further procedures depending on the outcome of that work and our assessment of the risk of material error taking into account the fund's investment holding at the year end. Derivatives can be complex in terms of accounting, measurement and disclosure requirements. We will first understand the rationale for the use of the derivatives and then test compliance with the accounting, measurement and disclosure requirements of the Code of Practice. The use of expert advice may be required for testing these balances.

2. Significant audit risks (continued)

Management override of controls		Deloitte response
Management override of controls is a presumed risk	We are required by ISA 240 'The auditors' responsibility to consider fraud in an audit of the financial statements' to presume there is a significant risk of management override of the system of internal control.	Our audit work will include: • Reviewing analysis and supporting documentation for journal entries, key estimates and judgements. • We will perform substantive testing on journal entries to confirm that they have a genuine, supportable rationale; • We will review ledgers for unusual items and on a test basis investigate the rationale of any such postings; • We will review significant management estimates and judgements such as year end accruals and provisions and consider whether they are reasonable; and We will make enquiries of those charged with governance as part of our planning and detailed audit processes.

3. Other issues

Whilst not considered to be a specific audit risk we set out our response to the significant change to the accounting systems this year

New bank account in operation		Deloitte response
The new bank account has required changes to the accounting system	In line with the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 the authority opened a separate bank account for the pension fund in 2011. The authority has now changed the accounting systems so that cash flows relating to the pension fund are processed through the fund's own account.	We understand from discussions with the officers, during our planning work, that the changes to the software are not complete and as such there are a number of manual reconciliations performed on balance sheet accounts. We will review these reconciliations as part of our audit process.

4. Consideration of fraud

The primary responsibility for the prevention and detection of fraud rests with management and those charged with governance, including establishing and maintaining internal controls over the reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations. As auditor, we obtain reasonable, but not absolute, assurance that the financial statements as a whole are free from material misstatement, whether caused by fraud or error.

ISA (UK and Ireland) 240 – 'The auditor's responsibility to consider fraud in an audit of financial statements' requires us to document an understanding of how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud in London Borough of Harrow Pension Fund and the internal control that management has established to mitigate these risks.

We will make inquiries of management, internal audit and others within the Authority as appropriate, regarding their knowledge of any actual, suspected or alleged fraud affecting the Authority. In addition we are required to discuss the following with the Governance, Audit and Risk Management Committee:

- Whether the Committee has knowledge of any fraud, alleged or suspected fraud?
- The role that the Committee exercises in oversight of:
    - London Borough of Harrow Authority's assessment of the risks of fraud in respect of the pension fund; and
    - the design and implementation of internal control to prevent and detect such fraud?
- The Governance, Audit and Risk management Committee's assessment of the risk that the pension fund financial statements and annual report may be materially misstated as a result of fraud.

5. Internal control

Obtaining an understanding of internal control relevant to the audit

As set out in "Briefing on audit matters", for controls considered to be 'relevant to the audit' we are required to evaluate the design of the controls and determine whether they have been implemented ("D & I"). The results of our work in obtaining an understanding of controls and any subsequent testing of the operational effectiveness of controls will be collated and the impact on the extent of substantive audit testing required will be considered. Our audit is not designed to provide assurance as to the overall effectiveness of the controls operating within the Authority or its pension fund administration, although we will report to management any recommendations on controls that we may have identified during the course of our audit work.

6. Timetable

		2012			2013									
		Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov
Management	Prepare plan based on discussions with officers				■									
	Early discussion of Authority's approach to risks areas				■									
	Performance of detailed planning work								■					
	Audit fieldwork									■	■			
	Audit close meetings										■			
	Review of pension fund annual report										■			
GARM Committee	Audit plan						■							
	Report to the GARM Committee on the 2012/13 accounts audit											■		

Our work during these visits will be closely co-ordinated with the work carried out on other parts of main audit of the London Borough of Harrow.

7. Responsibility statement

The Statement of Responsibilities of Auditors and Audited Bodies issued by the Audit Commission explains the respective responsibilities of auditors and of the audited body and this report is prepared on the basis of, and our audit work is carried out, in accordance with that statement.

This report should be read in conjunction with the "Briefing on audit matters" attached at Appendix 1 and sets out those audit matters of governance interest which came to our attention during the audit to date. Our audit was not designed to identify all matters that may be relevant to members and this report is not necessarily a comprehensive statement of all weaknesses which may exist in internal control or of all improvements which may be made.

This report has been prepared for the Members of the London Borough of Harrow Council, as a body, and we therefore accept responsibility to you alone for its contents. We accept no duty, responsibility or liability to any other parties, since this report has not been prepared, and is not intended, for any other purpose.

Deloitte LLP
Chartered Accountants

St Albans
19 March 2013

Appendix 1 Briefing on audit matters

Published for those charged with governance

This document is intended to assist those charged with governance to understand the major aspects of our audit approach, including explaining the key concepts behind the Deloitte Audit methodology including audit objectives and materiality.

Further, it describes the safeguards developed by Deloitte to counter threats to our independence and objectivity.

This document will only be reissued if significant changes to any of those matters highlighted above occur.

We will usually communicate our audit planning information and the findings from the audit separately. Where we issue separate reports these should be read in conjunction with this "Briefing on audit matters".

Approach and scope of the audit

Primary audit objectives

We conduct our audit in accordance with International Standards on Auditing (UK & Ireland) as adopted by the UK Auditing Practices Board ("APB"). Our statutory audit objectives are:

- to express an opinion in true and fair view terms to the trustees on the financial statements;
- to express an opinion as to whether the accounts have been properly prepared in accordance with the relevant financial reporting framework; and
- to form an opinion as to whether the financial statements contain the information specified in regulation 3 and the schedule to the Occupational Pension Schemes (Requirement to obtain Audited Accounts and a Statement from the Auditor) Regulations 1996.

Other reporting objectives

Our reporting objectives are to:

- present significant reporting findings to those charged with governance. This will highlight key judgements, important accounting policies and estimates and the application of new reporting requirements, as well as significant control observations; and
- provide timely and constructive letters of recommendation to management. This will include key business process improvements and significant controls weaknesses identified during our audit.

Appendix 1 Briefing on audit matters (continued)

Materiality

The concept of materiality is fundamental to the preparation of the financial statements and the audit process and applies not only to monetary misstatements but also to disclosure requirements and adherence to appropriate accounting principles and statutory requirements.

"Materiality" is defined in the International Accounting Standards Board's "Framework for the Preparation and Presentation of Financial Statements" in the following terms:

"Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful."

We determine materiality based on professional judgment in the context of our knowledge of the audited entity, including consideration of factors such as stakeholder expectations, sector developments, financial stability and reporting requirements for the financial statements. We use a different materiality for the examination of the summary contributions to that used for the financial statements as a whole.

We determine materiality to:

- determine the nature, timing and extent of audit procedures; and
- evaluate the effect of misstatements.

The extent of our procedures is not based on materiality alone but the quality of systems and controls in preventing material misstatement in the financial statements, and the level at which known and likely misstatements are tolerated by you in the preparation of the financial statements.

The materiality in relation to the audit of the pension scheme's financial statements will not necessarily coincide with the expectations of materiality of an individual member of the scheme in relation to his or her expected benefits. Our judgments about materiality are made in the context of the financial statements as a whole and the account balances and classes of transactions reported in those statements, rather than in the context of an individual member's designated assets, contributions or benefits.

Uncorrected misstatements

In accordance with International Standards on Auditing (UK and Ireland) ("ISAs (UK and Ireland)") we will communicate to you all uncorrected misstatements (including disclosure deficiencies) identified during our audit, other than those which we believe are clearly trivial.

ISAs (UK and Ireland) do not place numeric limits on the meaning of 'clearly trivial'. The Audit Engagement Partner, management and those charged with governance will agree an appropriate limit for 'clearly trivial'. In our report we will report all individual identified uncorrected misstatements in excess of this limit and other identified errors in aggregate.

We will consider identified misstatements in qualitative as well as quantitative terms.

Appendix 1 Briefing on audit matters (continued)

Audit methodology

Our audit methodology takes into account the changing requirements of auditing standards and adopts a risk based approach. We utilise technology in an efficient way to provide maximum value to trustees and create value for management and those charged with governance whilst minimising a "box ticking" approach.

Our audit methodology is designed to give trustees the confidence that they deserve.

Audit methodology (cont'd)

For controls considered to be 'relevant to the audit' we evaluate the design of the controls and determine whether they have been implemented ("D & I"). The controls that are determined to be relevant to the audit will include those:

- where we plan to obtain assurance through the testing of operating effectiveness;
- relating to identified risks (including the risk of fraud in revenue recognition, unless rebutted and the risk of management override of controls);
- where we consider we are unable to obtain sufficient audit assurance through substantive procedures alone; and
- to enable us to identify and assess the risks of material misstatement of the financial statements and design and perform further audit procedures.

Other requirements of International Standards on Auditing (UK and Ireland)

ISAs (UK and Ireland) require we communicate the following additional matters:

ISA (UK & Ireland)	Matter
ISQC 1	Quality control for firms that perform audits and review of financial statements, and other assurance and related services engagements
240	The auditor's responsibilities relating to fraud in an audit of financial statements
250	Consideration of laws and regulations in an audit of financial statements
265	Communicating deficiencies in internal control to those charged with governance and management
450	Evaluation of misstatements identified during the audit
505	External confirmations
510	Initial audit engagements – opening balances
550	Related parties
560	Subsequent events
570	Going concern
600	Special considerations – audits of group financial statements (including the work of component auditors)
705	Modifications to the opinion in the independent auditor's report
706	Emphasis of matter paragraphs and other matter paragraphs in the independent auditor's report
710	Comparative information – corresponding figures and comparative financial statements
720	Section A: The auditor's responsibilities relating to other information in documents containing audited financial statements

Appendix 1 Briefing on audit matters (continued)

Independence policies and procedures

Important safeguards and procedures have been developed by Deloitte to counter threats or perceived threats to our objectivity, which include the items set out below.

Safeguards and procedures

- Every opinion (not just statutory audit opinions) issued by Deloitte is subject to technical review by a member of our independent Professional Standards Review unit.
- Where appropriate, review and challenge takes place of key decisions by the Second Partner and by the Independent Review Partner, which goes beyond ISAs (UK and Ireland), and ensures the objectivity of our judgement is maintained.
- We report annually to those charged with governance our assessment of objectivity and independence. This report includes a summary of non-audit services provided together with fees receivable.
- There is formal consideration and review of the appropriateness of continuing the audit engagement before accepting reappointment.

Safeguards and procedures (cont'd)

- Periodic rotation takes place of the audit engagement partner and, where appropriate, the independent review partner and key partners involved in the audit in accordance with our policies and professional and regulatory requirements.
- In accordance with the Revised Ethical Standards issued by the APB, there is an assessment of the level of threat to objectivity and potential safeguards to combat these threats prior to acceptance of any non-audit engagement. This would include particular focus on threats arising from self-interest, self-review, management, advocacy, over-familiarity and intimidation.
- In the UK, statutory oversight and regulation of auditors is carried out by the Financial Reporting Council (FRC). The Firm's policies and procedures are subject to external monitoring by both the Audit Quality Review Team (AQRT, formerly known as the Audit Inspection Unit), which is part of the FRC's Conduct Division, and the ICAEW's Quality Assurance Department (QAD). The AQRT is charged with monitoring the quality of audits of economically significant entities and the QAD with monitoring statutory compliance of audits for all other entities. Both report to the ICAEW's Audit Registration Committee.

Appendix 1 Briefing on audit matters (continued)

Independence policies

Our detailed ethical policies' standards and independence policies are issued to all partners and employees who are required to confirm their compliance annually. We are also required to comply with the policies of other relevant professional and regulatory bodies.

Amongst other things, these policies:

- state that no Deloitte partner (or any immediate family member) is allowed to hold a financial interest in any of our UK audited entities;
- require that professional staff may not work on assignments if they (or any immediate family member) have a financial interest in the audited entity or a party to the transaction or if they have a beneficial interest in a trust holding a financial position in the audited entity;
- state that no person in a position to influence the conduct and outcome of the audit (or any immediate family member) should enter into business relationships with UK audited entities or their affiliates;
- prohibit any professional employee from obtaining gifts from audited entities unless the value is clearly insignificant; and
- provide safeguards against potential conflicts of interest.

Remuneration and evaluation policies

Partners are evaluated on roles and responsibilities they take within the firm including their technical ability and their ability to manage risk.

APB Revised Ethical Standards

The Auditing Practices Board (APB) has issued five ethical standards for auditors that apply a 'threats' and 'safeguards' approach.

The five standards cover:

- maintaining integrity, objectivity and independence;
- financial, business, employment and personal relationships between auditors and their audited entities;
- long association of audit partners and other audit team members with audit engagements;
- audit fees, remuneration and evaluation of the audit team, litigation between auditors and their audited entities, and gifts and hospitality received from audited entities; and
- non-audit services provided to audited entities.

Our policies and procedures comply with these standards.

This page is intentionally left blank

REPORT FOR: Pension Fund Committee

Date of Meeting:	25th June 2013
Subject:	**Information Report** - Update Report and Action Points from Previous Meetings
Responsible Officer:	Simon George, Director of Finance and Assurance
Exempt:	No.
Enclosures:	Appendix 1- Action Points Appendix 2 – Meeting Plan 2013-14 Appendix 3 – Membership and Remit

Section 1 – Summary and Recommendations

This report provides an update (appendix 1) of actions taken since the last meeting.

FOR INFORMATION

Harrow COUNCIL
LONDON

Section 2 – Report

1. An update of actions taken from prior meetings is summarised in appendix 1.

RBS Legal Action

2. At the March meeting the Committee discussed the potential to join a group legal action against Royal Bank of Scotland seeking compensation for losses suffered from participating in the 2008 rights. The claim arises from deficiencies in the prospectus relating to the rights issue.

3. When last discussed, the Committee sought further legal advice and details of participation by local authorities.

4. Since the March meeting Harrow's Legal team has reviewed the documentation and supports participation on a no win no fee basis provided that Harrow is protected against costs should the claim be lost. Documentation on the funding agreement and adverse cost cover is awaited. Neither has been finalised so far.

5. In terms of participating by Local Authorities, only one has positively committed so far. Another 14, including Harrow, joined a telephone conference call on 10 June 2013 and are actively considering participating.

6. Additional documentation is being discussed with Legal as it arises and Harrow will only participate if the Legal department are satisfied on the cost protection.

Section 3 – Further Information

7. See appendix 1.

Section 4 - Financial Implications

8. Financial implications are central to the issues discussed in the paper.

Section 5 – Equalities Implications

9. Was an Equality Impact Assessment carried out? Yes.

10. There are no direct equalities implications relating to the Pension Fund.

Section 6 - Corporate Priorities

11. Corporate Priorities are not applicable to the Pension Fund as it does not have a direct impact on Council's resources.

Section 7 - Statutory Officer Clearance

Name: Simon George Date: 10 June 2013	√	Chief Financial Officer
Name: Matthew Adams Date: 10 June 2013	√	on behalf of the Monitoring Officer

Section 8 - Contact Details / Background Papers

Contact: George Bruce (Treasury and Pension Fund Manager) Tel: 020-8424-1170 / Email: george.bruce@harrow.gov.uk

Background Papers: Nil

Appendix 1

London Borough of Harrow

Pension Fund Investment Panel

<u>Update Report and Action Points – 25th June 2013</u>

Issue/decision	Source	Action Taken	Next Steps
Market Update Report The equity allocation is reduced to 64% and proceeds held in cash to be used to fund investment in Standard Life GARS.	Nov 2010 Minute 49	The cash balance will be used to fund the DGF Mandates.	Complete.
Responsible Investment RESOLVED: That the report be deferred to a future meeting and officers, as part of this, be requested to address the comments above.	15 Nov 2011 Minute 125	Additional information on the legal position, union views, investment manager stance and income / cost impact is being collected.	Ongoing.
BlackRock Bond Opportunities The report was deferred for consideration at the next meeting.	Jun 2012 Minute 163	On the November meeting agenda	Review at November meeting – also covered in minute 209. Complete
Governance of the PFIP RESOLVED: (1) that the outline proposals for the terms of reference of the Pension Fund Investment Panel to be expanded, as set out in the report, be taken to the Constitution Review Working Group for consideration;	Nov 2012 Minute 186	A revised remit has been adopted by Council.	See Appendix 3 Complete
(2) that following (1) above, detailed proposals be drafted and recommended to the LGPC;			Complete
(3) that consideration be given to expand the membership of the Pension Fund Investment Panel to include two independent, co-opted members to act in an advisory		Investigation underway of remuneration levels for similar roles within other LBs	Ongoing

capacity;			
<u>Review of the Investment Strategy</u> RESOLVED: 1) 10% of the fund be invested in the selected fund managers (5% each to Standard Life and Barings); 2) the new managers to be funded from available cash and the balance to be withdrawn from the Fidelity mandate and that: 3) the revised strategy as shown in Appendix 2 of the report be approved subject to reflecting the lower 10% allocation to DGF mandates 4) the equity mandates be reviewed at the next meeting 5) the alternative fixed income products available from BlackRock be reviewed at a later date; 6) authority be delegated to the Section 151 Officer (or deputy) to sign any documentation required to complete the appointment of the selected DGF managers.	March 2013 Minute 209	Two DGF Managers were selected: Barings and Standard Life. £35 million was drawn-down with Fidelity.	£27 million was invested with Barings in May 2013. The Investment of £27 million with Standard Life is pending. Complete - SIP updated and included on agenda Complete – on agenda Carried forward Complete
<u>Meeting Plan 2013-14</u> **Resolved:** That (1) the report be noted; (2) an informal meeting to meet the equity fund managers be arranged for the May half term break. (3) Training to be provided prior to the commencement of the next meeting on 'good governance' and the CIPFA skills and knowledge framework.	March 2013 Minute 206	Equity fund manager meeting day at Harrow took place on 30th May 2013	Complete - Members who were unable to attend were forwarded materials from the day. On agenda On agenda

(4) An agenda item to be included at the next meeting on investing in infrastructure. 18th September 2013 25th November 2013 19th March 2014		See Appendix 2	
<u>London Pension Fund Merger</u> <u>Legal Action Against the Royal Bank of Scotland</u>	March 2013 Minute 207	Members were unanimous in their view that the Harrow Pension Fund should retain its autonomy. More information requested on those authorities already committed to the group action, and further advice on the probable outcome of any action.	On agenda. See comments above.
<u>Information Report - Investment Manager Monitoring</u> RESOLVED: That the report be noted.	March 2013 Minute 210	N/A	Complete.
Information Report - Performance of Fund Managers for Quarter Ended 31 December 2012 RESOLVED: That the report be noted.	March 2013 Minute 211	N/A	Complete.
<u>Update Report</u> That the report be noted.	March 2013 Minute 205	N/A	Complete.

Appendix 2

Meeting dates 2013-14

Quarter 3 18/09/13	**Quarter 4 25/11/13**	**Quarter 1 19/03/14**	
Manager Monitoring	Manager Monitoring	Manager Monitoring	
Valuation & performance	Valuation & performance	Valuation & performance	
Update Report	Update Report	Update Report	
Annual Accounts and Auditors' Report	Bond Options	Meeting plan 2014-15	
Investment & administration costs	Annual strategy monitoring & rebalancing	Property and private equity reviews	
Review of operational controls at Investment managers	Training on governance requirements arising from 2014 Regulations	Voting and engagement by fund managers	
Equity Options – detailed proposals			
Actuarial valuation			

PENSION FUND COMMITTEE

	Conservative	Labour	Independent Labour	Ungrouped
	(2)	(2)	(0)	(0)
I. Members	**Tony Ferrari** **Richard Romain (CH) ***	**Keith Ferry *** **Sachin Shah**		
II. Reserve Members	1. Stephen Wright 2. Kam Chana	1. Bill Phillips 2. Bill Stephenson		

Harrow UNISON Co-optee (Non-voting): Steve Compton
GMB Co-optee (Non-voting): Sanjay Karia
Co-optee (Non-voting): Howard Bluston

(CH) = Chair
* Denotes Group Members for consultation on Delegated Action and/or administrative matters.

PENSION FUND COMMITTEE

The Pension Fund Committee has the following powers and duties:

to exercise on behalf of the Council, all the powers and duties of the Council in relation to its functions as Administering Authority of the LB Harrow Pension Fund (the fund), save for those matters delegated to other Committees of the Council or to an Officer;

the determination of applications under the Local Government Superannuation Regulations and the Teachers' Superannuation Regulations;

to administer all matters concerning the Council's pension investments in accordance with the law and Council policy;

to establish a strategy for the disposition of the pension investment portfolio; and

to appoint and determine the investment managers' delegation of powers of management of the fund.

REPORT FOR: Pension Fund Committee

Date of Meeting:	25th June 2013
Subject:	London Pension Fund Collaboration
Responsible Officer:	Simon George, Director of Finance and Assurance
Exempt:	No.
Enclosures:	Local Government Ministers Speech Paper to the London Leaders' Committee

Section 1 – Summary and Recommendations

The Committee has previously expressed opposition to a forced merger of London pension funds. The Government will commence this year a consultation on views relating to collaboration and merger. Proposals to set up a voluntary collective investment vehicle (CIV) are being developed by the London Leaders.

Recommendation:

The Panel is invited to agree:

(a) to support the investigation and establishment of voluntary collaboration models for London pension funds, including a collective investment vehicle, and

(b) delegate authority to the Section 151 officer after consultation with the Chairman to approve expenditure relating to the investigation and set up costs of the CIV up to a limit of £50,000.

Harrow COUNCIL LONDON

Section 2 – Report

1. The Committee has been informed of ongoing discussions on the merits of the London LGPS schemes joining together to reduce costs and improve performance. At the March meeting the Committee expressed opposition to a forced merger. Developments since then include a speech from the minister responsible for Local government and further investigation by a working group formed jointly by the London Leaders' Committee and the Society of London Treasurers. Developments and suggested actions are set out below.

Speech by Brandon Lewis, Local Government Minister

2. Mr Lewis announced to the NAPF Local Government conference that the Government will be consulting later in the year on the options for change to the LGPS. He clearly feels that the evidence suggests that too much collectively is being paid in fees and that "the scheme could benefit from a smaller number of optimal funds". He then added that "there is clear agreement that doing nothing was not an option". A copy of the speech is attached.

3. In terms of desired outcomes the minister said these were "more transparency, better data, fewer unnecessary overheads and stronger, more consistent investment performance." This chimes with earlier statements from the DCLG that called for the case for merger to be properly examined. London is still seen as a target for greater collaboration.

4. The Committee will be kept informed of developments in good time to allow an agreed response to the consultation.

London Leaders / SLT Working Group

5. The London Leaders and Society of London Treasurers have been comparing a range of options for closer pension fund collaboration in terms of impact and practicality. The preferred option is a collective investment fund (CIV) that operates on a voluntary basis. The proposal is that the CIV will be a bridge between individual schemes and fund managers. The CIV will identify and monitor one or more fund managers for each asset class, agreeing fees. Individual schemes such as Harrow will then be able to opt into those arrangements.

6. The advantage of a CIV compared with merger is that there will be no change to the Harrow fund structure, no merger and the Committee will remain responsible for the investment strategy. The additional available choice will be that when it came to manager selection, Harrow is able to use the managers selected by the CIV. This might be across the whole fund or for specific asset classes only. Monitoring of fund managers and decisions to de-select could continue to be undertaken by Harrow, although this would also be a responsibility of the CIV. With additional resources and a larger mandate, the hope is that a CIV will result in improved investment performance, which is debateable and lower fees, a more reasonable expectation.

7. Already one London borough, Wandsworth, has come forward to offer to host the CIV. A copy of the latest Leaders paper on the issue is attached. Change to scheme benefit administration functions has taken a back seat for the moment.

Other Research

8. London pension funds have collected information on individual fund performance compared with the larger county council and concluded that while there is a wide distribution of returns across London, which might indicate poor management by some councils, that on average the larger county council's generate returns that were no higher than the London average. The research did suggest that there is scope for fee savings, but not to the extent suggested by earlier commentators.

Conclusion

9. It is clear that Government seeks change, possibly by compulsion if not achieved voluntarily. The CIV route now being investigated addresses many of the concerns raised in previous discussions on compulsory merger and possibly also has advantages compared with the current status:

   a) It leaves unchanged the structure of the scheme, the setting of strategy and the determination of manager mandate (active v passive).
   b) By operating at asset class level, it allows choice as to which asset classes should be collectively managed and which excluded.
   c) There is no compulsion and decisions to use the CIV can be reversed with costs no higher than a normal manager change and nil if no manager change is involved.
   d) Although the CIV will have running costs (staff, accommodation and advisors) these should be wholly offset by reduced management fees through larger pools of assets. Also, individual schemes may save on advisor fees.
   e) Direct supervision of managers <u>can</u> be delegated to the CIV saving Committee time and fees.
   f) Perhaps most importantly, by acting to achieve the fee savings and improved performance the Government expect from pooling assets, we may avoid more drastic action being imposed.

10. It is suggested that the Committee support further investigation of the CIV option and remain open minded about using a CIV. It is possible that Harrow will be asked to contribute to the investigation and set up costs of the CIV, and it is suggested that authority be delegated to the Section 151 officer after consultation with the Chairman to approve such expenditure up to a limit of £50,000. It is considered that if London Councils refuse to explore the potential for a CIV that the Government is more likely to force change, such as merge.

Financial Implications

11. Merger or collaboration will have a significant impact on the way the fund operates and the ability of the Committee to take decisions. The Committee and Council needs to be fully involved.

Risk Management Implications

12. Risk included on Directorate risk register? No

13. Separate risk register in place? No

14. Setting risk tolerances and measuring outcomes is central to the strategy.

Equalities implications

15. Was an Equality Impact Assessment carried out? Yes

16. There are no direct equalities implications relating to the pension fund.

Corporate Priorities

17. Corporate Priorities are not applicable to the Pension Fund as it does not have a direct impact on Council resources.

Legal Implications

18. The report has been reviewed by Legal Department and comments received are incorporated into the report.

Section 3 - Statutory Officer Clearance

Name: Simon George Date: 10 June 2013	√	Chief Financial Officer
Name: Matthew Adams Date: 10 June 2013	√	Monitoring Officer

Section 4 - Contact Details / Background Papers

Contact: George Bruce (Treasury and Pension Fund Manager) Tel: 020-8424-1170 / Email: george.bruce@harrow.gov.uk

Background Papers: Relevant press comments have been circulated.

If appropriate, does the report include the following considerations?

1.	Consultation	N/A
2.	Corporate Priorities	N/A

Speech by Local Government Minister Brandon Lewis on the local government pension scheme. Originally given at Cotswold Water Park Four Pillars Hotel. This is a transcript of the speech, exactly as it was delivered.

Introduction

Thank you very much Joanne [Segars, Chief Executive, NAPF] for that kind introduction and for inviting me to open the conference.

You asked me to speak about the new local government pension scheme (LGPS) that we will be introducing next April and I will of course do so. These reforms will reduce the cost of the LGPS to employers and taxpayers. But we also need to think more fundamentally about the way the LGPS is structured. The LGPS has an enviable record on scheme administration and many of you can be proud of what you are achieving. Nevertheless, the scheme has changed little since 1974. Is it still fit for purpose and can it deliver value for money for scheme members, employers and taxpayers?

LGPS reform

Six months ago I spoke at your local authority forum and set out the case for reform and our programme for bringing forward the new LGPS in April 2014. Much has happened since then. In December, we launched the first consultation on the main elements of the new scheme. Almost 150 responses were received which we took on board in a second consultation at the end of March. We received about 30 responses, which suggests to me that we got things pretty much spot on first time around.

The journey from a final salary defined benefit scheme to a new career average scheme, with all the required protections under the Public Service Pensions Act, was never going to be an easy one. There is still a great deal of work to do, including another consultation very shortly on draft administration and governance regulations. But despite the complexities and challenging timetable, we remain on track to deliver the key elements of the new scheme on time.

A great number of you in the audience will have helped to get us where we are today. We are in a good place because of your help and co-operation and I know that I can rely on you all to ensure that the new scheme is a success from the start.

Efficiency and cost effectiveness

Introducing the new scheme is a clear priority for us all, but since becoming Local Government Minister, I have also been clear that looking at other ways of achieving better value for money for taxpayers is equally, if not more important. After all, you are responsible for vast sums of money. You spend about £8 billion a year on pension benefits, while fund management and scheme administration costs alone are almost £500 million a year.

There are plenty of examples where local pension funds are already working together to share services, to establish local or national call-off contracts and in some cases, to pool pension fund assets. This is all good news, but I am equally aware that there are just as many authorities that are sitting on the sidelines waiting to be told what to do.

Many people associated with the LGPS, including a fair few in the audience today, have been to see me with their ideas. Most of them have said that if there are to be fewer funds, theirs should remain because it’s the best.

All of them have raised some important points. For example, most agree that we need to see the costs of administering funds and the fees paid to fund managers reduced. To achieve this, we need a better understanding of the factors driving these costs. In particular, I want to understand why the administration and fund management costs of similar fund authorities can vary so markedly.

Data

We need better data to help answer the question about what makes a good, strongly performing fund. It is all too simple to look at funding levels and on that basis, say that fund x is better than fund y. But I think we all know that the position is far more complex than that. Funding levels alone do not determine performance.

We need a more sophisticated model that takes account of other factors such as discount rate, investment returns, cash flow, recovery periods and perhaps, most importantly, the funding strategy statement and statement of investment principles adopted by individual funds. Only then will we be able to compare the performance of individual funds on a level playing field.

A common complaint I hear is that there is no single LGPS annual report. This is something we must address. Pension fund authorities are already required to publish their own pension fund reports and I have no wish to change that arrangement. But academics, trades unions and others tell me they are fed up with having to obtain and then collate 89 different reports to end up with the national picture. I have therefore asked my officials to open discussions with scheme stakeholders to agree the format and content of an annual scheme report to sit alongside individual fund reports.

Investments

The scheme is becoming increasingly mature and it is no secret that some funds are close to becoming cash-negative. We therefore need to see even better and more consistent returns on the £150 billion worth of investments in the scheme.

I therefore want to undertake a root and branch review of the LGPS investment regulations. Some have suggested that the funds should be better directed to support growth, particularly local growth. We have already taken steps to allow fund authorities to increase their exposure to limited liability partnerships, but I accept that we may need to go further.

In particular, I want to know if there are any other obstacles in the regulations that prevent you from maximizing your returns. I am not suggesting that we should dispense altogether with the requirement for you to assess the risks associated with your investments. After all, this is taxpayers' money you are investing and we must continue to get the right balance between risk and reward.

Funding deficits

My other priority is to tackle the equally important issue of fund deficits. We can't bury our heads in the sand and just keep pushing these significant costs on to future generations of employers and taxpayers.

I want to develop a clear strategy that will both address the historical deficits that have built up over past decades and ensure that future funding levels remain at a level which are fair and affordable. I don't underestimate the challenge I have set myself but this is not a problem I can choose to ignore. With your help, I want to find a better way to manage deficits. For example, is their a case for moving away from the concept of long term solvency as a funding target and moving towards a model that looks at cash flows and a fund's capacity to meet pension payments over the short and medium terms?

Fund mergers

I now want to say something about fund mergers. There is probably no other issue on the LGPS radar that attracts such diverse and forthright views. I recognise the tensions out there, and no doubt in the room today, but I am clear that we must explore every option that might give employers and taxpayers a better deal.

Opinion is clearly divided on the issue of whether "big is better", but for me, the real question is whether "small is worse". There is compelling evidence from around the world to suggest that the scheme could benefit from a smaller number of optimal funds. But some of you contend that small funds can perform on a par with larger ones. Both sides are equally convinced of their case.

Local Government Association/Department for Communities and Local Government roundtable

All of these issues were raised at a very useful roundtable meeting at the department last week, and I am grateful to the LGA for making that happen.

I was unable to stay for the whole meeting, but I am reliably informed that the discussion was lively and wide-ranging. I expected no less. Among the many different views expressed by trade unionists, academics, politicians and practitioners, a number of common themes emerged.

There was clear agreement that doing nothing was not an option. We can and will put in place a new regulatory framework for April 2014, but this needs to work within a structure that is efficient, cost effective and offers the best value for money. Concerns were raised about the pace of any change and I respect that view. Having the new scheme in place by April next year has to be our number one priority, but at the same time, we cannot afford to just keep talking about structural reform. We need clear objectives and a clear strategy to achieve change.

I was also pleased to learn that a clear consensus had emerged on the need for more focused and better scheme data. Different parties had different ideas about what those needs are, and various attendees said that they would be prepared to lend their experience and expertise in helping to develop a new dataset that better meets today's needs. I see this as an essential first step in the process to reform the structure of the LGPS.

The point was also made that we need to find a better way of managing pension liabilities to ensure that all future pension payments can be met. It was suggested that a few funds are already cash negative and eating into their assets in order to pay pensions. I think we can all agree that this is not making the best use of fund assets.

It is perhaps no surprise that the issue of fund mergers loomed large in the discussion. The arguments for and against fund mergers were, as ever, well made.

The way forward

So what is the way forward? What is clear to me is that things need to change. We need more transparency, better data, fewer unnecessary overheads and stronger, more consistent investment performance.

What we do not have at this point is agreement on the best way of achieving these goals.

But I am determined that we make progress and make it as quickly as reasonably possible. I can therefore announce this morning, that we will consult later in the year on a number of broad principles for change. This will be your opportunity to tell us what reforms could be made to both help improve your investment performance and reduce your fund management costs.

The consultation will not set out some pre-determined solution to what is undoubtedly a complex and contentious issue. I am neither ruling anything in nor ruling anything out at this stage. However, the clear message from me this morning is that I am not wedded to the existing number of 89 funds in England and Wales. If it takes a smaller number of funds to improve the efficiency and cost-effectiveness of the scheme, I shall not shy away from pursuing that goal.

I have talked a fair amount about the need for robust data to inform decisions. I am therefore working with the LGA and others to launch a call for evidence, which will both inform our consultation and help all involved formulate their views in response to the consultation.

You will be aware that work is well underway to establish a shadow national pensions board for the LGPS. I have met with the LGA and local government trades unions on several occasions to discuss the sort of work that I would like the board to undertake.

I hope I have left them in no doubt that I see work on structural reform of the LGPS, as well as pension liabilities and fund deficits, being one of their first priorities. I have also impressed on them the need for the shadow board to work alongside other representative groups, all of whom must have a say in how we take forward this key element of the reform process.

There is of course the temptation to put all of this to one side and put all our efforts into getting the new scheme in place for April. I appreciate the valuable contribution you are all making to that end, but I believe that I must press forward.

I want good scheme regulations working within a reformed structure that is cost effective and affordable to those who pay the scheme's costs. I am open to the idea that change itself may have to wait until after the new scheme has been introduced, but I am determined to get you thinking now about what changes we need and how they can be achieved.

Conclusion

By the time we meet again next year, the new LGPS scheme will be up and running. On the equally important matter of structural reform, I fully anticipate that we will have a clear way forward to which we are all committed.

Leaders' Committee

Pensions Working Group: Progress update

Item no: 6

Report by:	Chris Buss	**Job title:**	Director of Finance, LB Wandsworth
	Chris Bilsland		Chamberlain, City of London Corporation
	Hugh Grover		Director Fair Funding, Performance & Procurement, London Councils
Date:	14 May 2013		
Contact Officer:	Hugh Grover		
Telephone:	020 7934 9942	**Email:**	Hugh.grover@londoncouncils.gov.uk

Summary

This report follows on from previous discussions on the potential for more collaboration between those London Boroughs that wished to do so, on the management and investment of pension funds.

It concludes that the focus of any such collaboration should be to optimise investment returns whilst the potential to make administrative savings, whilst important, should be the secondary consideration.

The report has been prepared by officers from London local government and London Councils supporting the member led working group established by Leaders' Committee towards the end of 2012.

Whilst there are several options for voluntary collaboration, a Common Investment Vehicle (CIV) is seen as the model which offers the best potential and it is recommended that further detailed work is undertaken on governance and a procurement strategy so that a fully worked up proposal may be submitted for future consideration.

Recommendations

Leaders' Committee is recommended to:

i. Note the work undertaken by the Working Group on considering the route towards establishing a potential CIV;

ii. Commission the Working Group, to undertake further work, and report back on those issues which would need to be addressed in the setting up of any future CIV, including:

a. Detailed consideration of possible governance mechanisms;

b. A potential procurement strategy; and

c. Options for establishing a possible host entity or Special Purpose Vehicle.

iii. Agree in principle to move towards a CIV for those boroughs who wish to, subject to Leaders' Committee consideration of the outcome of the further work by the Working Group.

Pensions Working Group: Progress update

Background

1. The issue of potential economies arising from merging the administration and investment arrangements has been under discussion for a number of years. In March 2012, Leaders' Committee received a report from the London Pensions Fund Authority (LPFA) on the potential for a London pension mutual and a common investment vehicle (CIV). The Society of London Treasurers (SLT) also provided advice to Leaders' Committee on the potential for both a mutual and a CIV. The SLT advice also raised a number of questions that it suggested would need addressing before any final decisions could sensibly be taken. Leaders' Committee commissioned further work to be done to looking at the questions raised. Following that meeting, SLT then commissioned work from the consultants PwC which was presented to the 13 November 2012 Leaders' Committee meeting. The report addressed the questions raised by SLT and identified four possible options that could provide ways forward:

    a. Collective Investment Funds,

    b. London Framework Fund,

    c. Common Investments Merger and a

    d. Full Merger.

2. The PwC report only considered the first two options as potentially viable at the present time.

3. Following discussion in November 2012, Leaders' Committee resolved that a small working group of members and officers should be formed to consider the advice from PwC in more detail and to report back with recommendations before the summer of 2013. A report to the 11 December meeting of Leaders' Committee proposed terms of reference and membership (the three Group Leaders and representatives from SLT) for the group.

4. The consensus among the Working Group is that although some savings could accrue from the joint administration of investments and/or benefits administration, the largest financial benefit to London pension funds would accrue from better investment returns and this should be the focus of attention. With that in mind it was agreed that the SLT representatives would conduct a survey of the Society to see what the appetite would be to work towards a CIV.

A Collective Investment Vehicle

5. A CIV (or fund) is a structure whereby each of the participating boroughs - and it should be stressed that participation by boroughs would be voluntary - would retain autonomy in asset allocation and funding strategy. There would be a host entity, or Special Purpose Vehicle, working within new governance arrangements, that establishes a choice of funds within each asset class, selects fund managers and negotiates and monitors fee and service levels. The participating boroughs would set their asset allocation, choosing between wide ranges of Investment Funds offered.

6. SLT members were surveyed and 26 responses were received, none of which were against the concept of a CIV, although the majority said that they would need to know more before definitely deciding whether to use such a vehicle. However, despite this element of natural caution, it is considered that such a vehicle should be further investigated, particularly in the light of other changes happening in the wider LGPS landscape.

7. SLT representatives also met with Aon Hewitt who are engaged in a similar review in Wales. There, grouping Welsh LGPS assets into a collective investment vehicle is the recommended way forward as it is believed to be an attractive model which could deliver the same benefits as a wholesale merger, particularly greater investment returns and fund efficiencies, but without the associated transition costs, complexity or lengthy implementation timescales. A note summarising the work of the Welsh group is appended.

8. SLT has also noted a number of press statements from the LPFA which talk about "One Fund for London" but it is not thought that there has been any formal dialogue with the London Boroughs on this.

View of Central Government

9. The publicly stated view of the Government as to the working of the 100 plus LGPS schemes in the UK has been, until recently, that there were no plans to actively merge schemes. However, the following extract from the January 2013 Local Government Pension Scheme Policy Review Group is informative1.

   i. "*DCLG explained that Ministers believed that the case for amalgamation should be properly examined. There would be a call for evidence in the next six months. Funds were not generally supportive of full merger. Fund merger*

[1] http://www.clg.heywood.co.uk/system/files/PRG+minutes+10+Jan.doc

would necessitate increased borrowing. There would also be a need to legislate and Ministers were reluctant to do this. There was a view that London would be a target area for mergers, but the performance of a number of London authorities had improved from below the average to considerably above in recent years. It was felt that the end result of such considerations was likely to be increased collaboration, particularly regarding investment."

10. Subsequent to that meeting, the LGA is convening a pensions round table on May 16th at which the SLT will be represented and at which the Minister (Brandon Lewis MP) will attend to open the session and share his thoughts in this area. It is understood that these views will include a desire to reduce the number of funds nationally. It is unclear at present whether, if this is so, this would be via compulsion or on a voluntary basis. However, the retention of the status quo is unlikely to be on the Government's agenda.

11. At its meeting on April 19th, SLT discussed further the options available to London collectively and concluded that the retention of the current arrangements of 33 borough level funds working within their individual arrangements was unlikely to be tenable in the long-term future. It also felt that a CIV was the practical option for joint working in the short to medium-term and that, for some of the boroughs, this could be a first step to voluntary merger(s). A merger by compulsion was not supported for a variety of reasons, including current and future cost, risk of cross subsidy and loss of democratic oversight.

Establishing a CIV

12. As stated earlier, the savings from aggregating administration are relatively minor compared to the benefits from better investment returns. Neither is there compelling evidence that the 'bigger is better' argument wins against the 'small is beautiful', or vice versa. However, there is evidence that there is a wide divergence of performance in London which is not related to fund size and more to asset allocation decisions. In the light of this and the consensus to explore further collaborative working on a voluntary basis, there is an immediate need to investigate the setting up of a CIV enabling boroughs to pool resources to improve the position not only in respect of fee levels, but try and achieve better performance overall.

13. The establishment of a CIV would need either a host entity or the establishment of a Special Purpose Vehicle (SPV). The former would be quicker to establish than the latter and the host entity could conceivably be a lead borough, London Councils or the LPFA

for example. It would be premature to recommend any of these as a preferred option at this point and, undoubtedly, legal advice would be needed before any such recommendation could be made.

14. Some initial work has been undertaken on the timescale for setting up a CIV in terms of the appointment of an investment fund advisor. At present, the 33 London funds employ 10 different advisors, although 3 firms account for 24 appointments. The procurement of a fund advisor for the CIV would involve an EU tender and the likely timescale would be in the region of 9 months from decision to commencement of service. Once this was in place decisions could be made on fund managers. Based on initial legal advice, the latter would be a non EU procurement and would be based upon the recommendations of the approved fund advisor.

15. There has been some suggestion that the fund managers could be directly employed by the CIV and this was suggested by LPFA in their original suggestion. However, this would need further research

16. The costs of establishing a CIV with funds in the region of £2 billion, which is 10% of London borough funds under management as at March 2012, would, based upon some initial market soundings, be in the region of £600,000-£900,000 depending upon how many fund manager categories are appointed and the level of devolvement by individual boroughs to the CIV, and the level of set up costs to be recovered from future running costs. However, this represents 0.03%-0.045% (3-4.5 basis points) of the funds under management and a saving of that amount should be achieved on reduced fees achieved through the tendering exercise.

<u>Some Governance Considerations</u>

17. Initial funding for a host entity or SPV would come from participating authorities, but once established would be more than paid for from reduced fees. The lead body would procure an investment advisor followed by a transition manager and investment funds/fund managers within each asset class, including alternatives like infrastructure.

18. The CIV would maintain a “best of breed” selection of funds/ managers for each asset class. These would be well defined, generally segregated mandates, with the CIV using its buying power to secure lower investment manager fees. The CIV would be responsible for day-to-day governance in relation to each selected manager, including, in conjunction with the appointed investment advisor, performing necessary due diligence for the chosen managers. This would include quarterly meetings with

managers and providing quarterly reports for borough pensions committees that summarise performance and any other pertinent information for the due diligence.

19. Boroughs would be free to choose which, if any, manager, to use from the CIV. Boroughs would not be compelled to use any CIV manager, but clearly, best-in-breed managers at the lowest cost obtainable should make the selection of managers desirable. One of the first asset classes to be investigated would be Infrastructure.

20. Individual funds would retain their own custodians, control over asset allocation, and accounting responsibilities, although manager related information would be supplied by the CIV. In time, the CIV could also be used to provide any other officer related investment duties that boroughs voluntarily wished to delegate, for instance if key staff left a particular borough – this could extend to preparing draft reports for all investment related matters for the local pensions committee, using a common custodian and preparation of accounts etc.

21. If and when appropriate, funds/managers would be deselected and recommendations for change would be made. Boroughs would be free to focus their investment governance budget on the asset allocation – the key driver of investment performance.

22. The Common Investment Vehicle model would not affect the triennial valuation process which would remain as currently.

<u>Next Steps and Recommendations</u>

23. The establishment of a CIV for pensions investment operated on behalf of the boroughs is clearly feasible and with a minimum level of buy in is potentially financially attractive. However, it does require a level of buy in at a political as well as technical level from councils to establish whether the initial interest of boroughs can be converted into real interest to make the initial investment in setting up the CIV worthwhile.

24. Leaders' Committee is recommended to:

    i. Note the work undertaken by the Working Group on considering the route towards establishing a potential CIV;

    ii. Commission the Working Group, to undertake further work, and report back on those issues which would need to be addressed in the setting up of any future CIV, including:

        a. Detailed consideration of possible governance mechanisms;

        b. A potential procurement strategy; and

c. Options for establishing a possible host entity or Special Purpose Vehicle.

iii. Agree in principle to move towards a CIV for those boroughs who wish to, subject to Leaders' Committee consideration of the outcome of the further work by the Working Group.

Financial Implications for London Councils

None at this time

Legal Implications for London Councils

None at this time

Equalities Implications for London Councils

None

Appendices

Annex A: Welsh Local Government Pension Funds Working Together, March 2013

Background Papers

13 March 2012 Leaders' Committee report:
http://www.londoncouncils.gov.uk/committees/agenda.htm?pk_agenda_items=4796

13 November 2012 Leaders' Committee report:
http://www.londoncouncils.gov.uk/committees/agenda.htm?pk_agenda_items=5072

11 December 2012 Leaders' Committee report:
http://www.londoncouncils.gov.uk/committees/agenda.htm?pk_agenda_items=5109

By virtue of paragraph(s) 3 of Part 1 of Schedule 12A
of the Local Government Act 1972.

Document is Restricted

This page is intentionally left blank

By virtue of paragraph(s) 3 of Part 1 of Schedule 12A
of the Local Government Act 1972.

Document is Restricted

This page is intentionally left blank

By virtue of paragraph(s) 3 of Part 1 of Schedule 12A
of the Local Government Act 1972.

Document is Restricted

This page is intentionally left blank

Document is Restricted

This page is intentionally left blank