Pension Fund Committee

Date Tuesday 15 December 2015

Time 10.00 am

Venue Committee Room 1A/1B, County Hall, Durham

Business

Part A

1. Apologies for Absence
2. Declarations of interest (if any)
3. The Minutes of the Meeting held on 10 September 2015 (Pages 1 - 6)
4. Graphs showing recent movements of the Stock and Share Indices (Pages 7 - 26)
5. Graphs showing recent movements of the major currencies against sterling (Pages 27 - 32)
6. Overall Value of Pension Fund Investments to 30 September 2015 (Pages 33 - 38)
7. Short Term Investments for the Period Ended 30 September 2015 (Pages 39 - 40)
8. Internal Audit Progress Report to 30 September 2015 (Pages 41 - 44)
9. Local Government Pension Scheme Investment Regulations (Pages 45 - 82)
10. Local Government Pension Scheme: Investment Reform Criteria and Guidance (Pages 83 - 112)
11. Audit Completion Report for the Year Ended 31 March 2015 (Pages 113 - 134)
12. Such other business as, in the opinion of the Chairman of the Meeting is of sufficient urgency to warrant consideration

13. Any resolution relating to the exclusion of the public during the discussion of items containing exempt information

Part B

Items during which it is considered the meeting will not be open to the public (consideration of exempt or confidential information)

14. The Minutes of the Meeting held on 10 September 2015 (Pages 135 - 144)
15. Report of the Pension Fund Adviser (Pages 145 - 148)
16. Report of BNY Mellon Investment Management (Pages 149 - 158)
17. Report of Aberdeen Asset Management (Pages 159 - 182)
18. Report of Mondrian Investment Partners (Pages 183 - 222)
19. Report of AB (Pages 223 - 228)
20. Report of CBRE Global Investment Partners (Pages 229 - 242)
21. Report of Royal London Asset Management (Pages 243 - 302)
22. Report of BlackRock (Pages 303 - 318)
23. Such other business as, in the opinion of the Chairman of the meeting, is of sufficient urgency to warrant consideration

Colette Longbottom
Head of Legal and Democratic Services

County Hall
Durham
7 December 2015

To: The Members of the Pension Fund Committee

County Council Members:
Councillors A Turner, W Stelling, J Alvey, C Carr, M Davinson, I Geldard, B Kellett, J Lethbridge, N Martin, J Shuttleworth and H Smith

Darlington Borough Council Members
Councillor S Harker
Councillor I G Haszeldine

Scheduled Bodies Representative
(vacant)

Admitted Bodies Representative:
J Norton

Pensioner Representative
D Ford

Active Members Representative
(vacant)

Further Education Colleges Representative
(vacancy)

Advisers: County Council Officers

Chief Executive	G Garlick
Corporate Director, Resources	D McLure
Head of Legal and Democratic Services	C Longbottom
Strategic Finance Manager – Corporate Finance	H Appleton

Independent Advisers
P Williams - P J Williams
R Bowker - P-Solve
D Banks - P-Solve

Investment Managers
BNY Mellon Investment Management
Aberdeen Asset Management
Mondrian Investment Partners
AB
CBRE Global Investment Partners
Royal London Asset Management
BlackRock

Staff Observers

UNISON	N Hancock
GMB	

Contact: Jill Errington **Tel: 03000 269703**

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DURHAM COUNTY COUNCIL

PENSION FUND COMMITTEE

At a Meeting of **Pension Fund Committee** held in Committee Room 2, County Hall, Durham on **Thursday 10 September 2015 at 10.00 am**

Present:

Councillor A Turner (Chairman)

Members of the Committee:
Councillors C Carr, M Davinson, B Kellett, J Lethbridge, N Martin, J Shuttleworth and H Smith

Darlington Borough Council Members:
Councillor S Harker

Pensioner Representative:
D Ford

Also Present:
County Council Advisers
D McLure – Corporate Director, Resources
H Appleton – Strategic Finance Manager – Corporate Finance
N Orton – Team Leader Operations and Data/Pensions

Independent Advisers
P Williams – P J Williams
R Bowker – P-Solve
D Banks – P-Solve

1 Apologies for Absence

Apologies for absence were received from Councillor J Alvey, W Stelling and Admitted Bodies representative John Norton.

2 Declarations of interest

There were no declarations of interest.

3 Minutes

The Minutes of the meeting held on 4 June 2015 were agreed as a correct record and were signed by the Chairman.

Councillor Shuttleworth referred to training for new Members of the Committee which had been raised at the last meeting and was informed that this would be addressed.

At this point item numbered 25 on the Agenda was brought forward to be considered under Part A. Members were informed that in future Internal Audit Progress Reports would be considered in Part A unless there was any confidential information to be reported.

4 Internal Audit Progress Report to 30 June 2015

Consideration was given to the report of the Corporate Director, Resources which outlined progress made in delivering the agreed internal audit plan relevant to the Pension Fund Committee for 2015/2016 (for copy see file of Minutes).

Resolved:

That the work undertaken by Internal Audit during the period ending 30 June 2015, and the assurance on the control environment be noted.

5 Graphs showing recent movements of the Stock and Share Indices

Consideration was given to graphs showing recent movements in the Stock and Share Indices (for copy see file of Minutes).

The graphs captured the beginning of the setback in equity markets and Robbie Bowker, P-Solve explained the market conditions in the first few days of September 2015. The UK market was down by almost 6% with emerging markets down 14%.

The stock market sell-off had been triggered by events in China. China was the second largest economy and a big importer, and was therefore very important in the world-wide market. Commodities also fell by 15% which affected emerging markets. When the news of China broke, huge daily market volatility resulted. Equity markets remained volatile and investors were nervous, taking a more defensive approach.

In response to questions from Councillors Shuttleworth and Martin about the potential impact on interest rates, Robbie Bowker advised that there was a lot of pressure on bond markets as private pension schemes looked to purchase. Banks were also buying more bonds putting additional pressure on the bond market and this was keeping interest rates suppressed. However he did not envisage that interest rates would increase to levels previously seen.

In terms of liabilities, because investors were being risk averse, long-dated bonds had been the best performing asset in the 3 month period. This was a difficult environment for pension schemes as the value of liabilities rose sharply.

Resolved:

That the information given be noted.

6 Graphs showing recent movements of the major currencies against sterling

Consideration was given to graphs showing recent movements of the major currencies against sterling (for copy see file of Minutes).

Resolved:

That the information given be noted.

7 Performance Measurement of Pension Fund Investments to 30 June 2015

Consideration was given to the report of the Corporate Director, Resources which gave an overview of the performance of the Fund to 30 June 2015 (for copy see file of Minutes).

The report gave details of the Managers' performance against their benchmarks for the quarter, the year to date and since inception of the Fund.

Members were informed that representatives from J P Morgan would give a presentation to Members under Part B of the Agenda on current services the custodian provided and new products.

Resolved:

That the information contained in the report produced by J P Morgan be noted.

8 Overall Value of Pension Fund Investments to 30 June 2015

Consideration was given to the report of the Corporate Director, Resources which informed Members of the overall value of the Pension Fund as at 30 June 2015, and of any additional sums available to the Managers for further investment or amounts to be withdrawn from Managers (for copy see file of Minutes).

Councillor Martin referred to Appendix 1 of the report and noted a transaction in 'other contributions' of £7m. Don McLure, Corporate Director, Resources advised that this was a payment from Durham Constabulary's cash reserves to reduce deficit payments.

Resolved:

That the information contained in the report be noted.

9 Short Term Investments for the Period Ended 30 June 2015

Consideration was given to the report of the Corporate Director, Resources which provided the Committee with information on the performance of the Pension Fund's short term investments as at 30 June 2015 (for copy see file of Minutes).

Resolved:

That the position as at 30 June 2015 regarding the Pension Fund's short term investments where £60,448 net interest was earned in the three month period, be noted.

10 Pension Fund Policy Documents - Funding Strategy Statement (FSS) and Statement of Investment Principles (SIP)

Consideration was given to the report of the Corporate Director, Resources which informed Members of the outcome of the consultation regarding the FSS and SIP and sought approval of the documents (for copy see file of Minutes).

Resolved:

That the contents of the revised Pension Fund's policy documents be approved for publication on the Council's website.

11 Statement of Accounts for the Year Ended 31 March 2015

Consideration was given to the report of the Corporate Director, Resources which presented the Pension Fund Accounts for the year ended 31 March 2015 (for copy see file of Minutes).

Hilary Appleton, Strategic Finance Manager – Corporate Finance directed Members to key information from the Accounts which was set out in paragraph 12 of the report.

The Audit Completion Report would be presented to Members in December 2015, together with an Action Plan designed to address any Auditor's recommendations at the conclusion of the Audit.

Resolved:

That the contents of the report be noted.

12 Self-Assessment of the Pension Fund Committee

Consideration was given to the report of the Corporate Director, Resources which sought to review the role of the Pension Fund Committee and summarised the activities and achievements in 2014/2015 that demonstrated how the Committee had fulfilled its role in order to be able to complete a self-assessment in line with the Terms of Reference (for copy see file of Minutes).

Members considered the process for self-assessment; whether additional information and/or reports were required and whether any training requirements had been identified.

Don McLure advised that the proposed training session identified for new Members would also be a useful tool to inform the self-assessment process. Councillor Martin suggested that training could also provide an opportunity to look at other key areas such as the FSS and SIP, how the Authority approached ethical investments and how the new global investment managers were working.

David Ford concurred with the views of Councillor Martin which he felt might help to inform the Committee of reports it wished to receive in future. He suggested that Members be forwarded the report and be asked to consider each of the recommendations listed in paragraph 26.

Resolved:

That the report be circulated to Members of the Committee to give consideration to the recommendations listed in paragraph 26, and comments be forwarded to Hilary Appleton, Strategic Finance Manager – Corporate Finance. A further report to be submitted to the next meeting of the Committee.

13 Pooling of LGPS Investments

Consideration was given to the report of the Corporate Director, Resources which provided Members with an update on Government proposals for pooling of investments in the Local Government Pension Scheme (for copy see file of Minutes).

In response to a question from Councillor Carr, Don McLure advised that it had been suggested in the local government financial press that there would be an emphasis on the size of the pools, expected to be in the tens of £billions, and regionally the value of Pension Funds may not be sufficient to meet the Government's criteria.

Councillor Martin made the comment that there may be some administrative savings and he could see the advantage of this in areas such as London which had a number of small Boroughs. The size of a pooled investment vehicle would make a difference in terms of achieving value and the use of passive investments would be inadvisable.

Following a question from Councillor Davinson, Daniel Banks of P-Solve confirmed that it may be difficult to exit a large pooled investment quickly, particularly if the vehicle investment was in infrastructure.

David Ford was of the view that becoming a small part of a large pooled fund may not be beneficial, and the clear advantages should be demonstrated before agreeing to participate in any pooled investment vehicle.

Resolved:

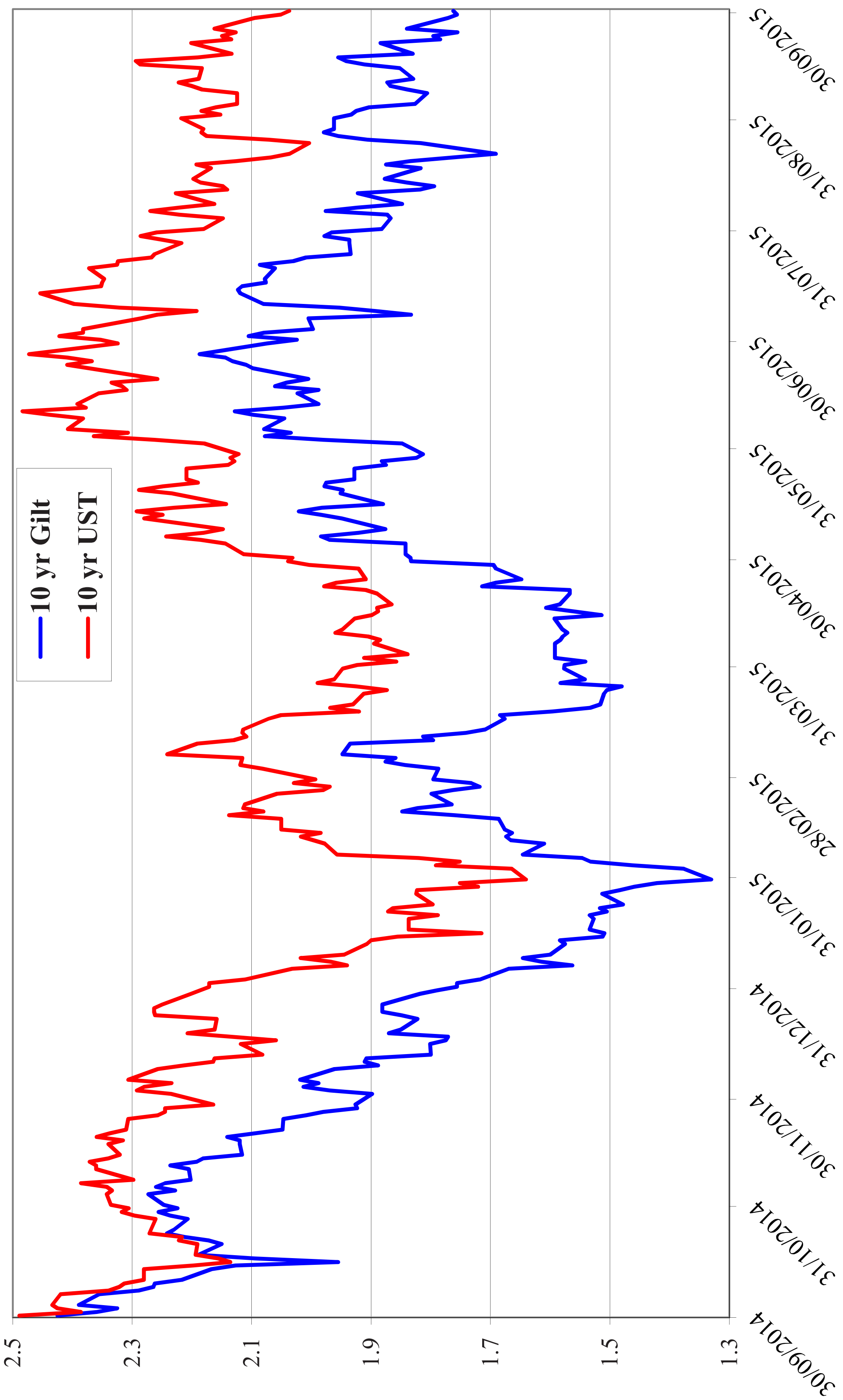
That the information contained in the report be noted.

14 Annual General Meeting of the Pension Fund to be held on 5 November 2015

Consideration was given to the report of the Corporate Director, Resources which informed of arrangements for the Annual General Meeting of the Pension Fund (for copy see file of Minutes).

Resolved:

That the date of the Annual General Meeting on 5 November 2015, be noted together with the invitation for Members to attend.


10 yr Gilt
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30/11/2014
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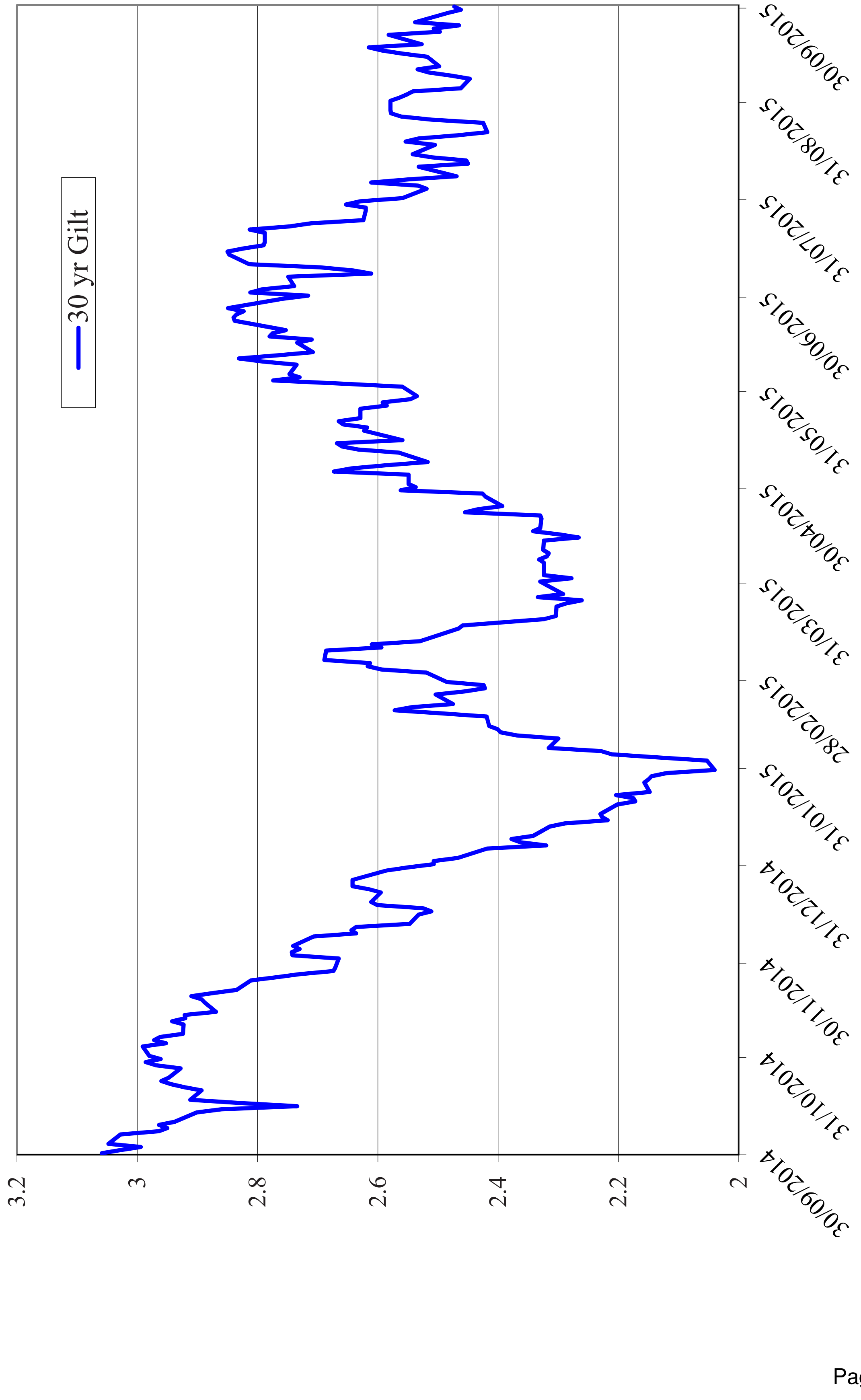
30 yr Gilt
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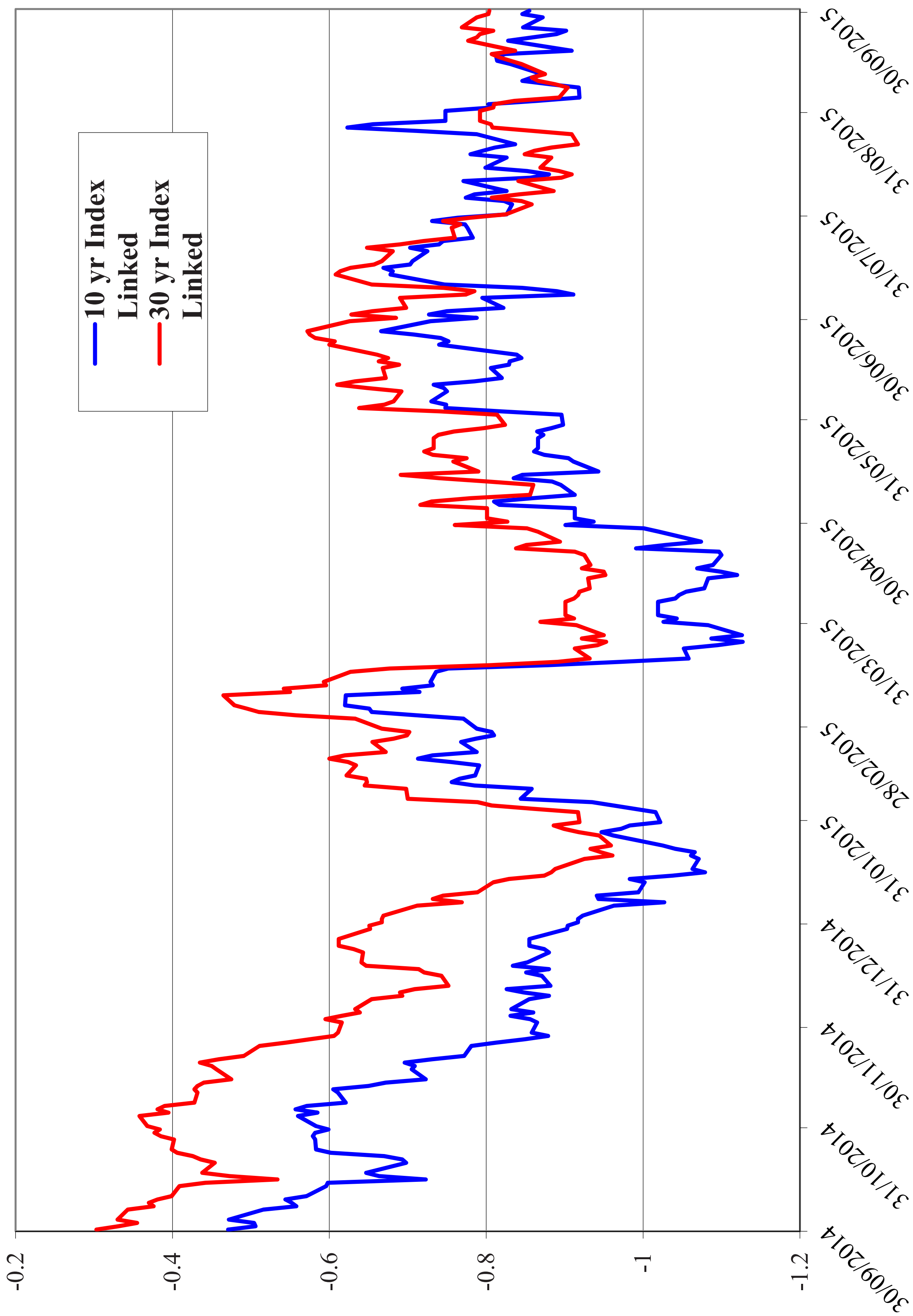
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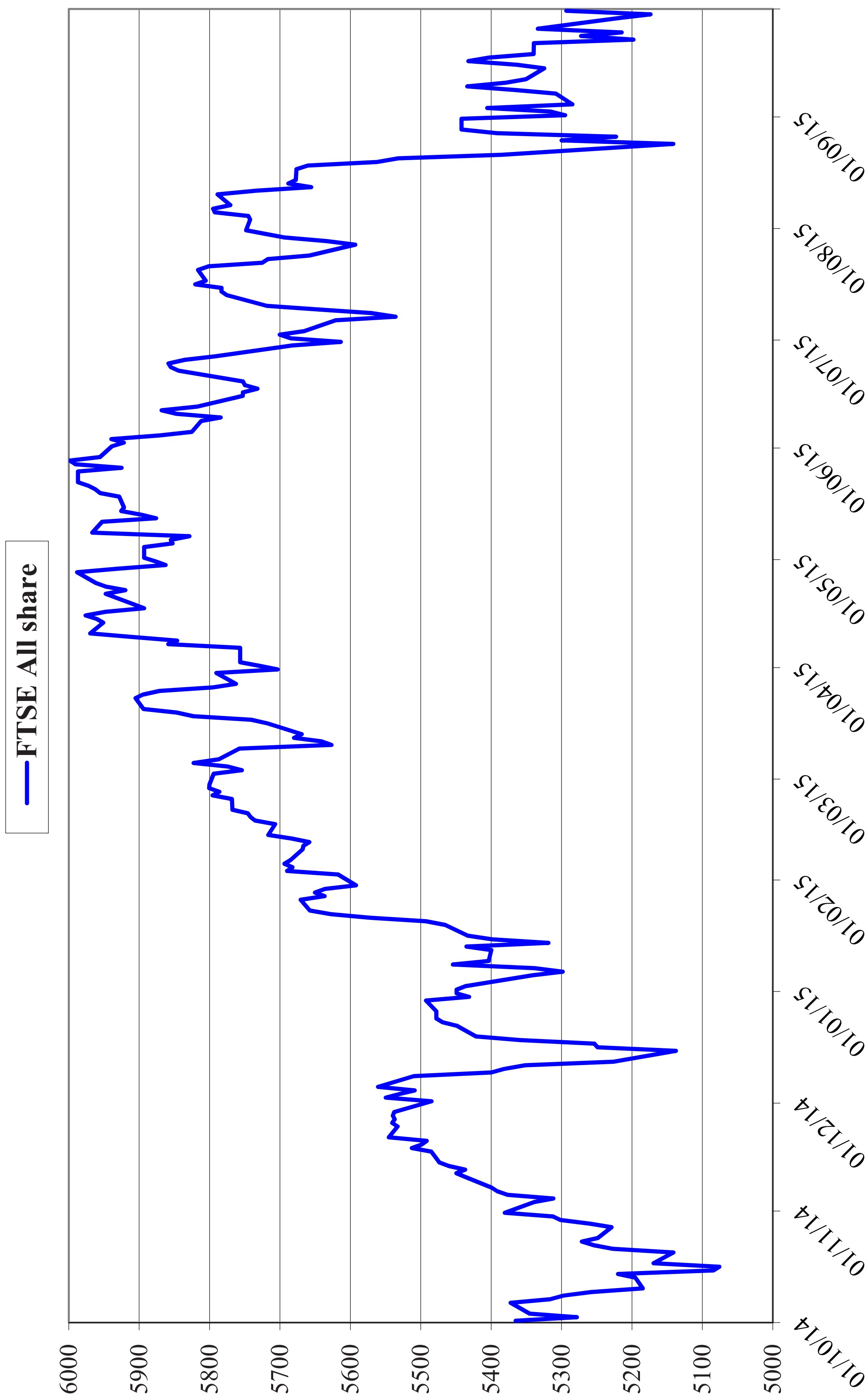
FTSE All share
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5900
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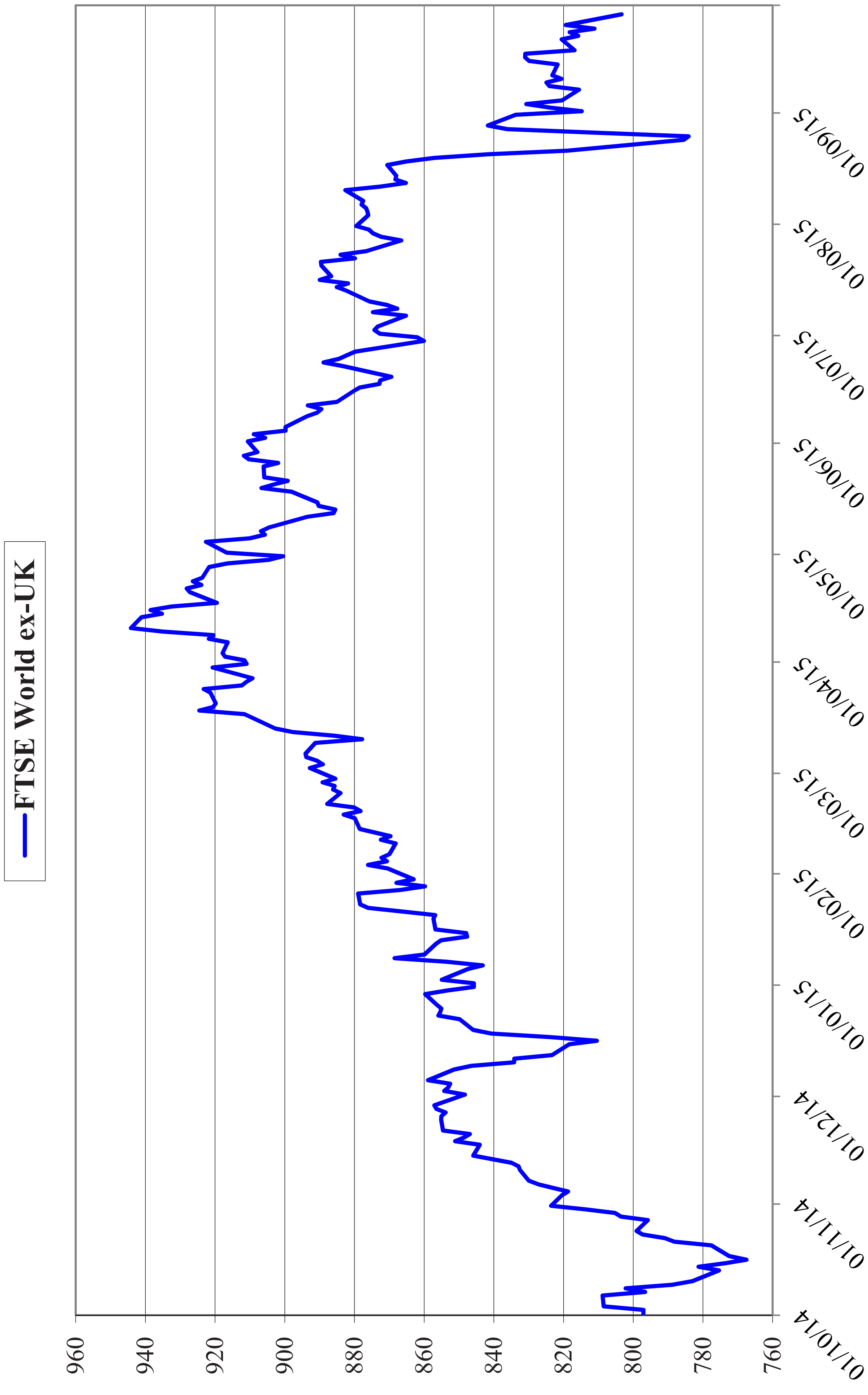

FTSE World ex-UK
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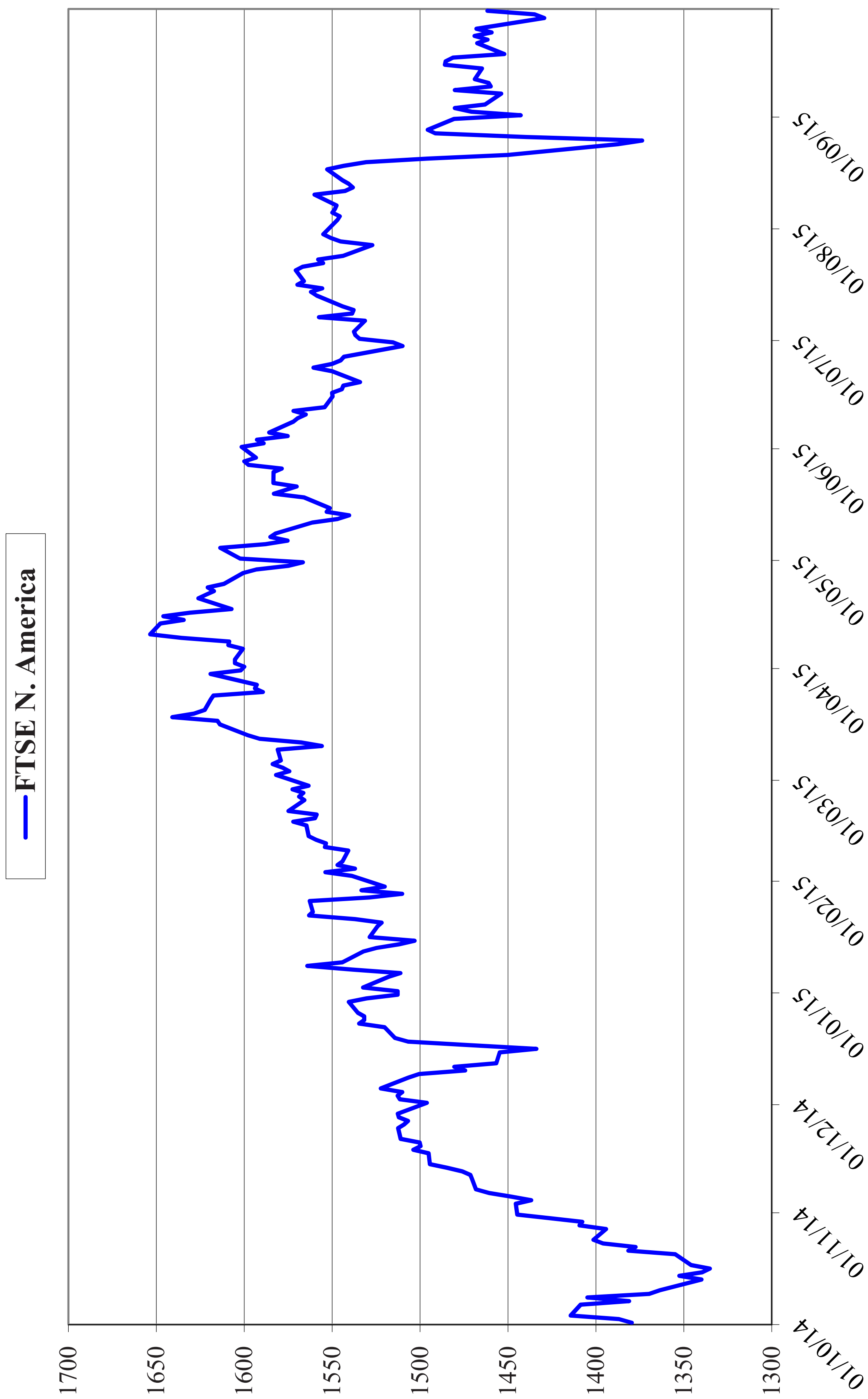
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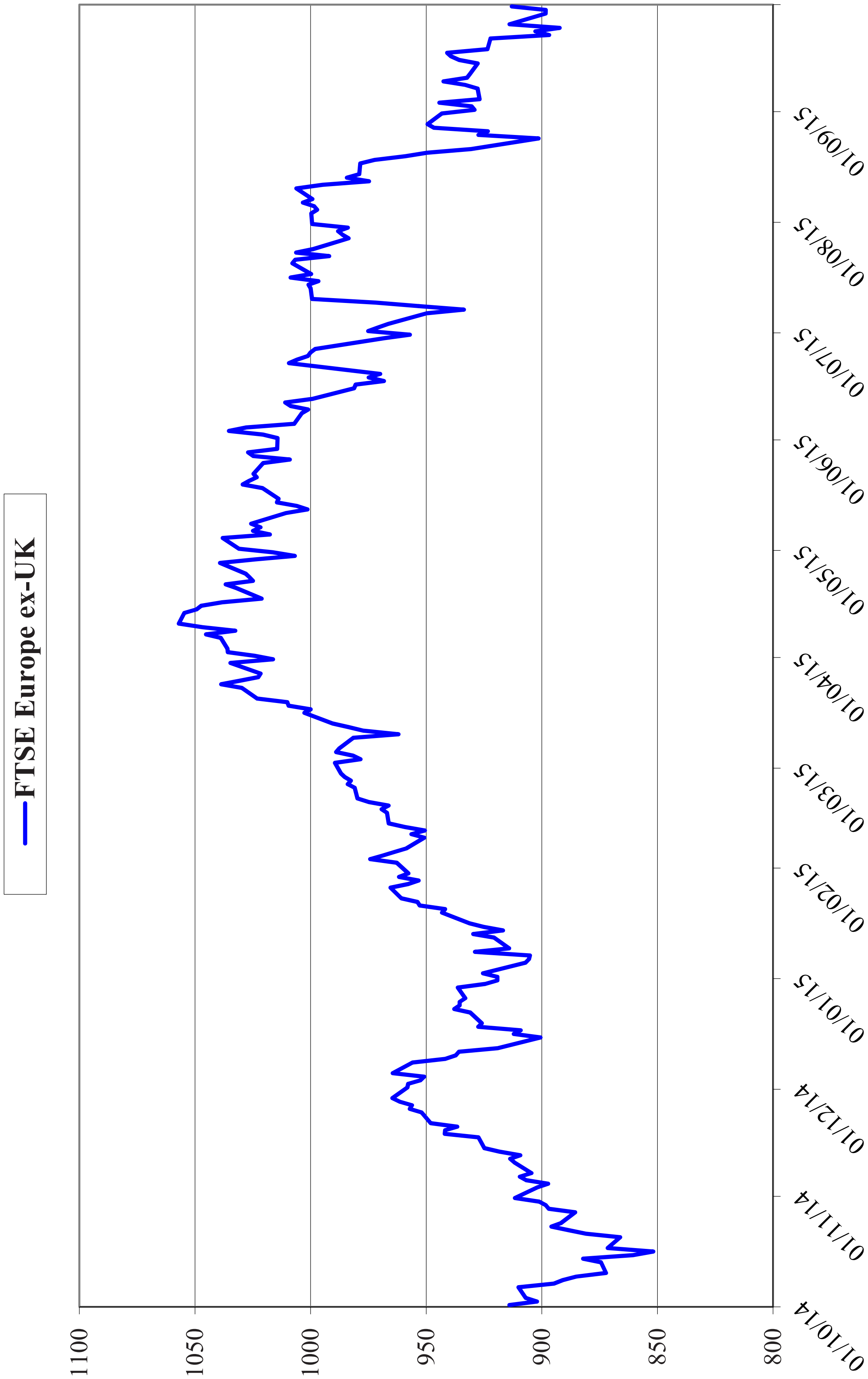
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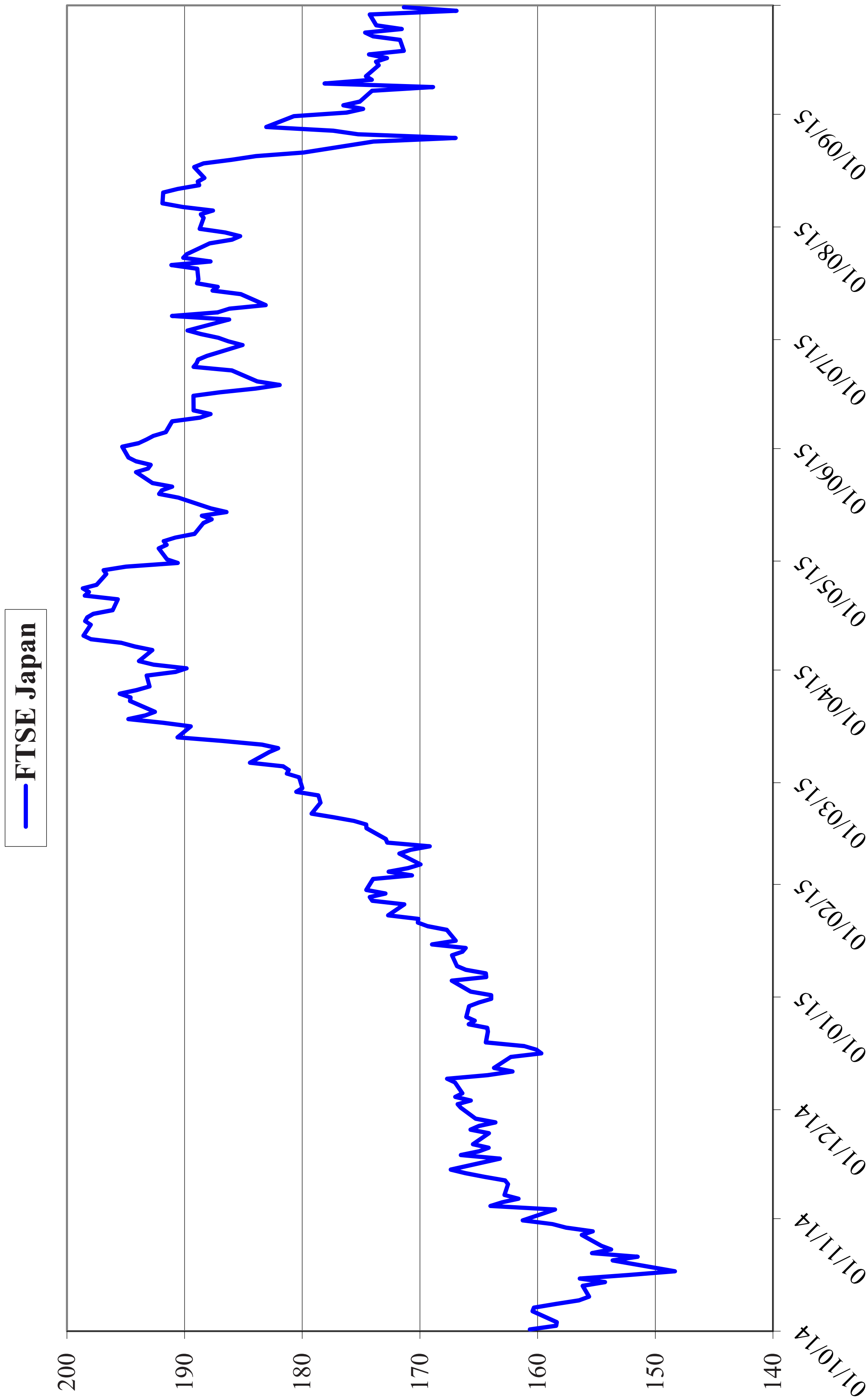

FTSE Japan
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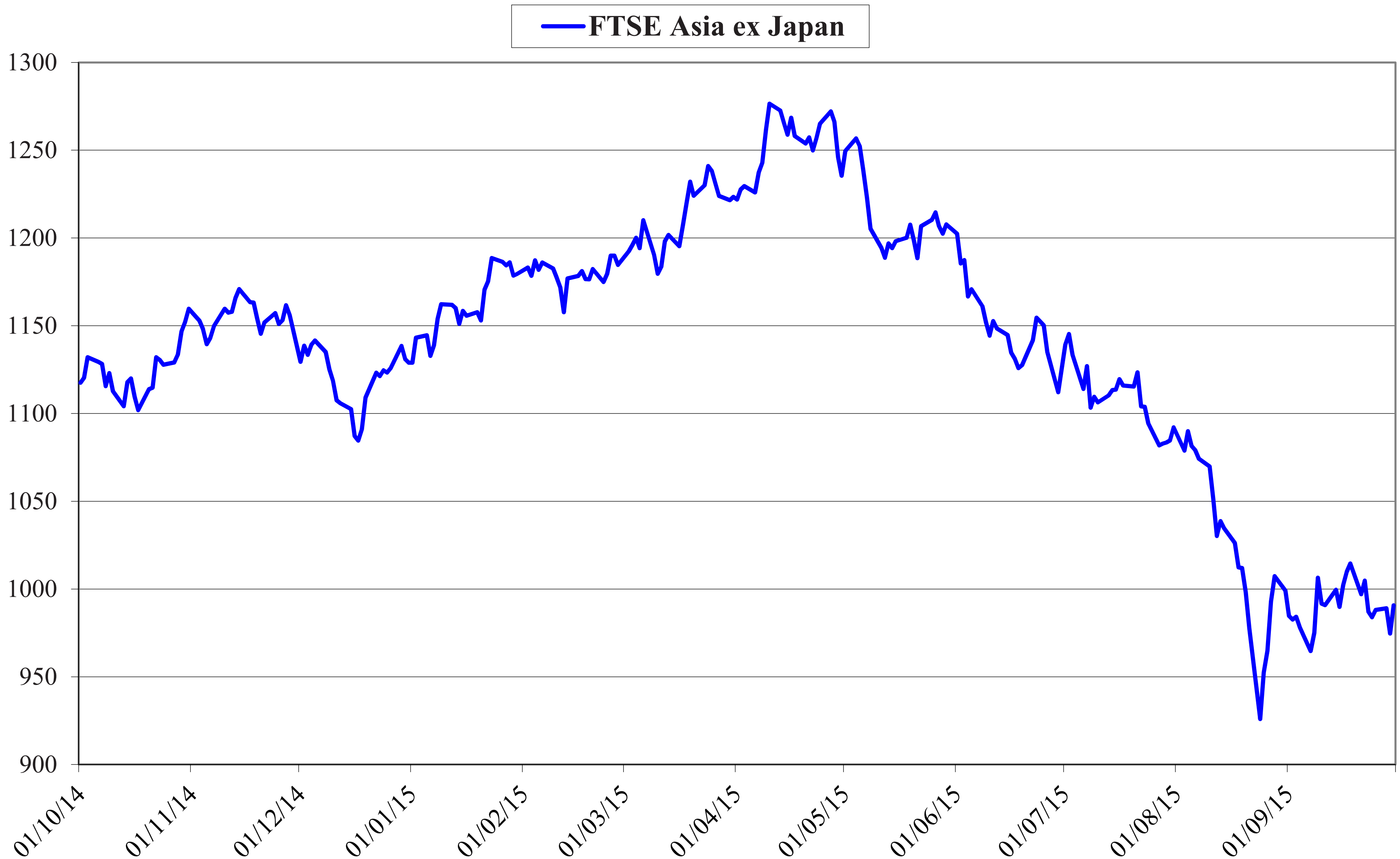
FTSE Asia ex Japan
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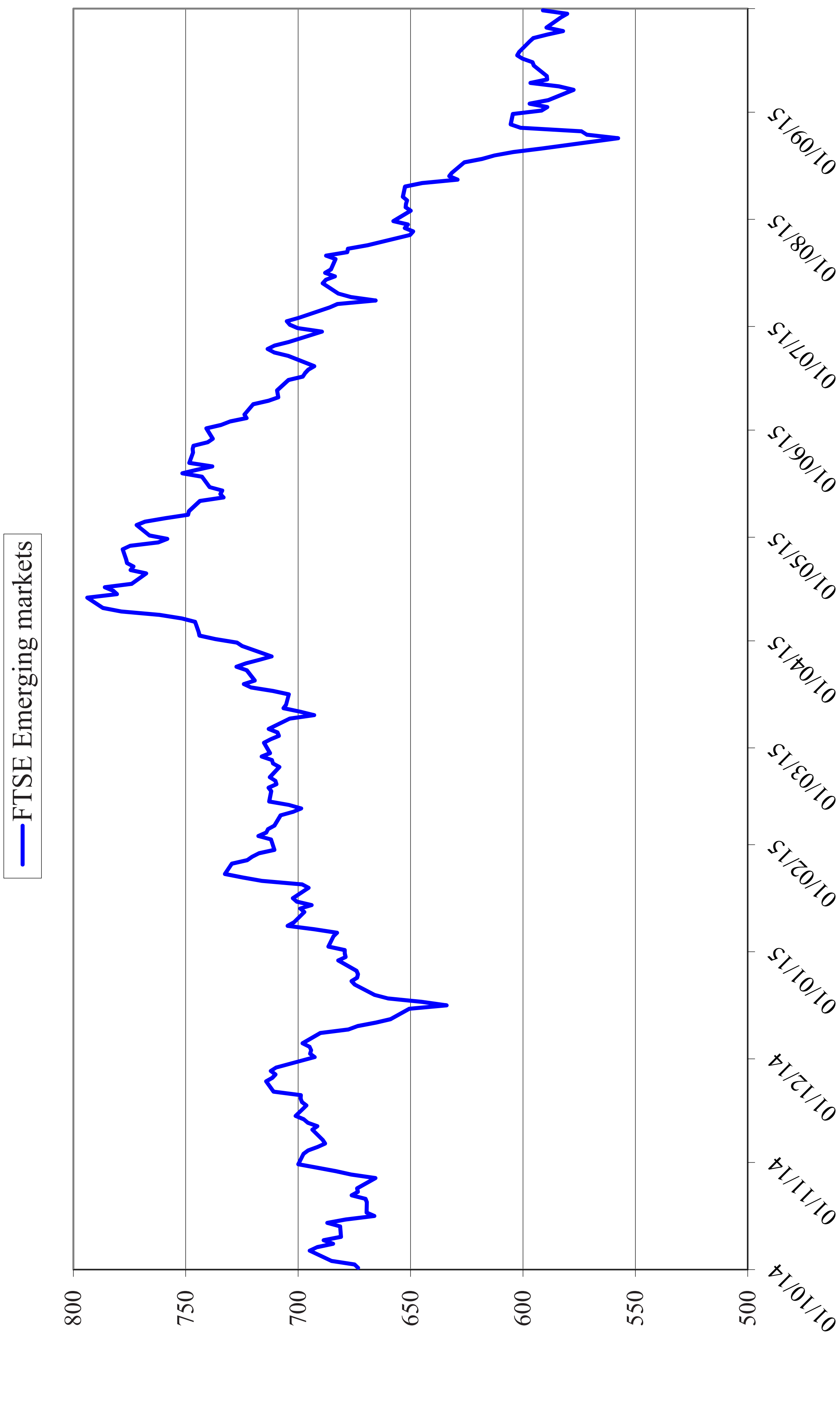
FTSE Emerging markets
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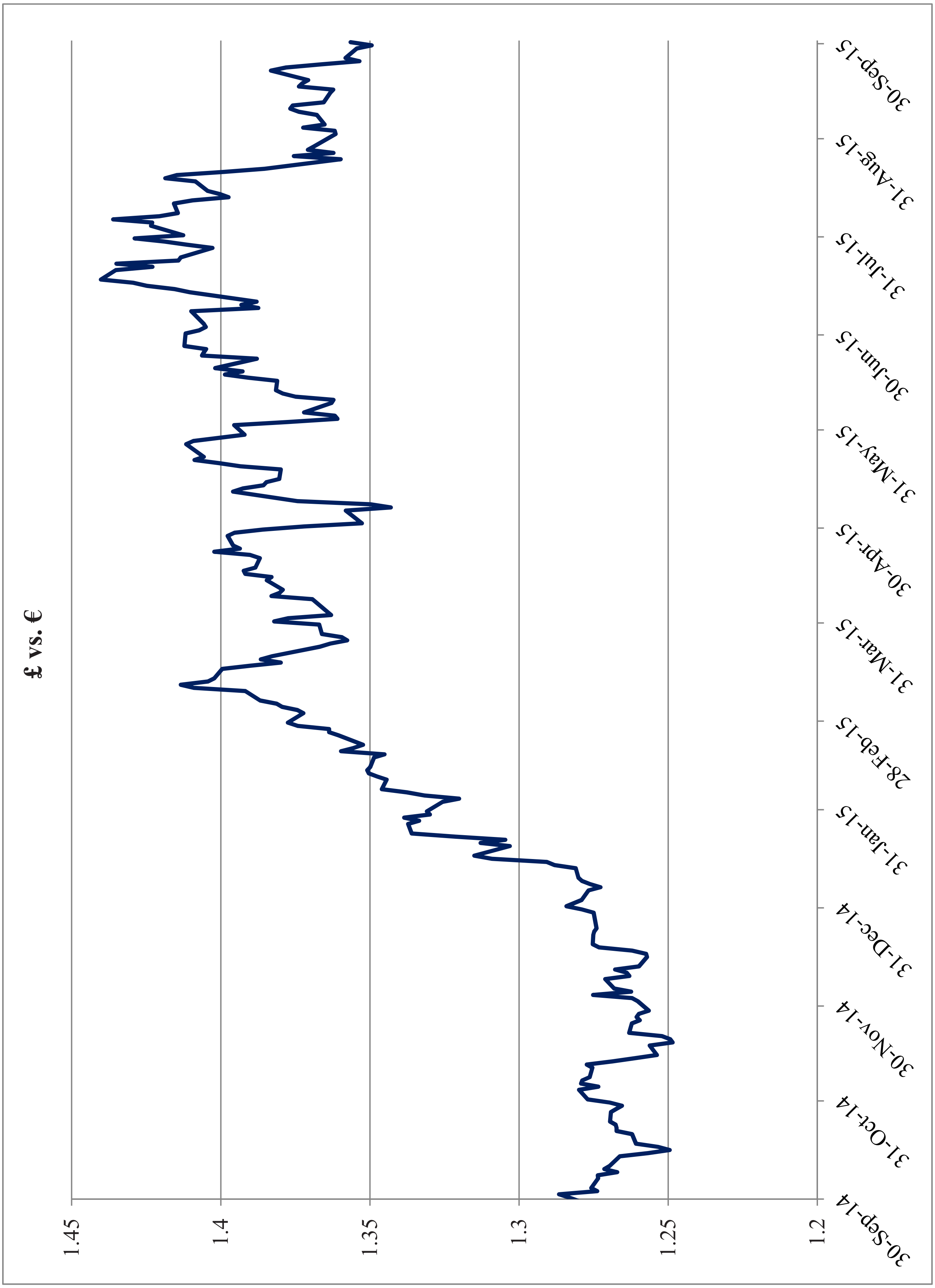
£ vs. €
1.45
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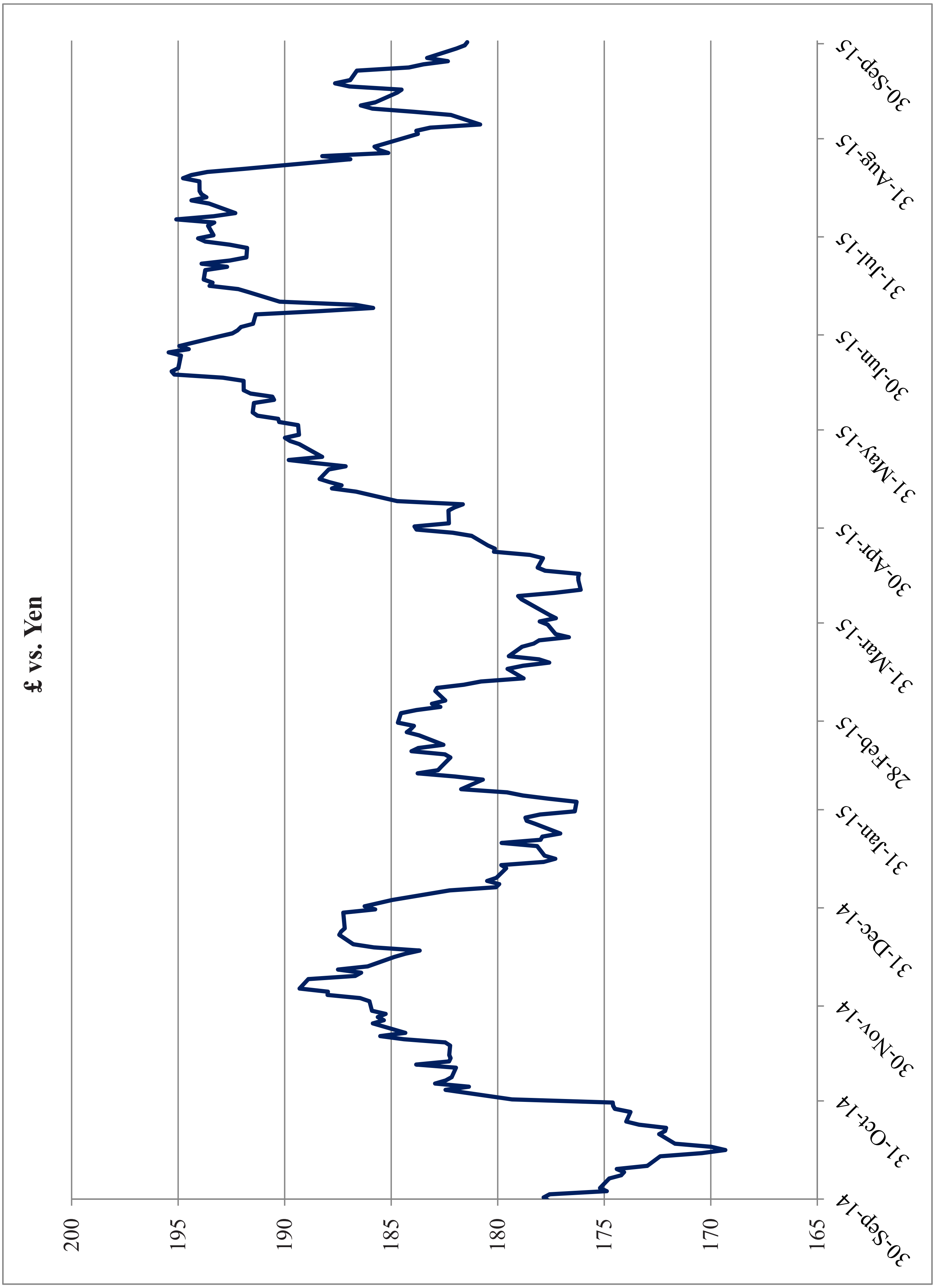

£ vs. Yen
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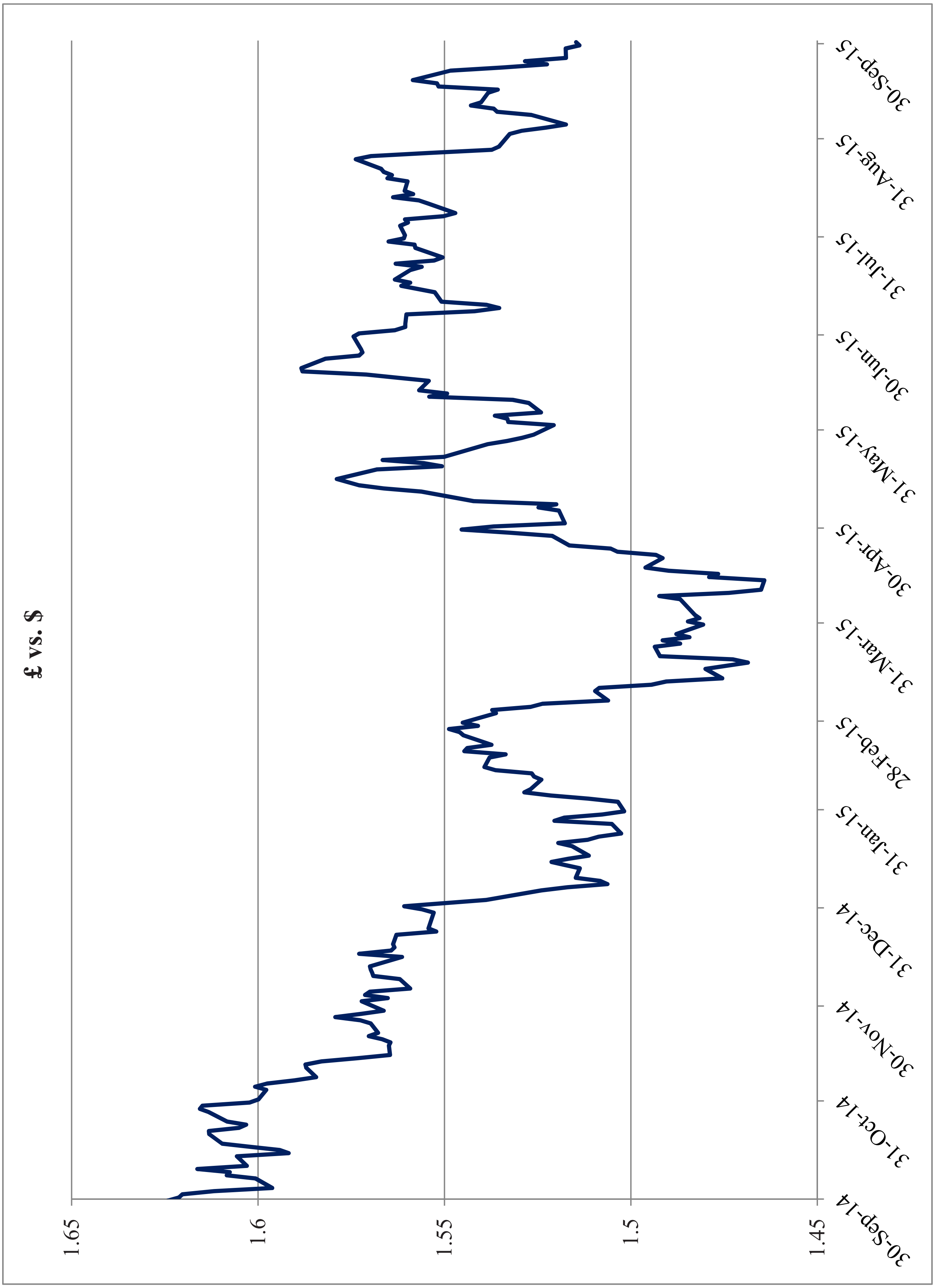
£ vs. $
1.65
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30-Sep-15

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Pension Fund Committee

15 December 2015

Overall Value of Pension Fund Investments to 30 September 2015

Don McLure, Corporate Director Resources

Purpose of the Report

1. To inform Members of the overall value of the Pension Fund as at 30 September 2015 and of any additional sums available to the Managers for further investment or amounts to be withdrawn from Managers.

Value of the Pension Fund

2. Reports from the seven appointed Managers:

   - Aberdeen
   - AllianceBernstein
   - BlackRock
   - Bank of New York (Walter Scott)
   - CB Richard Ellis
   - Mondrian
   - Royal London

   are included in other papers within this agenda. The value of the Fund at 30 September 2015 was £2 billion,129.64 million.

3. The value of the Fund as at June 2015 was £2 billion, 205.49 million. The value of the fund therefore decreased by £75.85 million in the second quarter of 2015/16.

Allocation of New Investment Money and Withdrawal of Investment Money to Deal with Estimated Deficit

4. New investment money is allocated to Investment Managers when the Pension Fund has cash which is not needed to be available as a working cash balance, for example for the payment of pensioners and fees.

5. When it is estimated that the Pension Fund will not have sufficient cash available as a working cash balance, cash is withdrawn from Investment Managers.

6. Appendix 1 details the working cash balance position of the Pension Fund and cash flow for the last four quarters, and an estimated cash flow for the

quarter ending 31 December 2015. This table includes only cash held by Durham County Council Pension Fund Bank Account. It does not include cash balances of £104.36m held by the Managers as at 30 September 2015.

7. In determining the amount of cash to be allocated to Managers as at the quarter ended 30 September 2015, the un-invested cash balance at the end of the previous quarter, together with interest received in that quarter, is considered. This does not include cash currently held by Fund Managers.

8. The amount allocated to each Manager is subject to the need to retain enough money in the Durham County Council Pension Fund Bank account to meet the Fund's estimated net cash outflow. After taking these issues into account, it is recommended that no money be added to the sums to be allocated to the Managers for investment in the quarter.

Cash Flow Forecast 2015/ 2016

9. Appendix 2 shows the projected cash flow for the Pension Fund for the period December 2015 to December 2016.

10. This table shows that the Pension Fund is estimated to be in deficit in each quarter of the forthcoming year. However, it should be noted that this is only in respect of the bank account held by the Pension Fund; income received from investments is currently held by Managers. When this is taken into account, the Pension Fund is forecasted to have a positive cash flow.

11. The quarterly rebalancing exercise is the mechanism by which cash can be moved from Managers to the Pension Fund if the assumptions that have been used in calculating the forecasted cash flow are realised.

12. The following assumptions have been used to calculate the cash flow forecast:

- Dividend income receivable in 2015/16 is estimated to be £30.0m, which is based on the actual figures to 31 March 2015. This income is profiled to be received in the same pattern as then, that is:

  - Quarter ended 31 March 21%
  - Quarter ended 30 June 34%
  - Quarter ended 30 September 27%
  - Quarter ended 31 December 18%

- Increases in contributions in line with the Actuarial Valuation are included.

- ‘Transfer values in’ are estimated at £0.500m per quarter. It is anticipated that transfers in will continue as LGPS will remain relatively attractive to employees.

- Pension increases will be at broadly the same level as 2014/15.

- Payroll Paysheets (payments to pensioners) are forecast to increase by £0.100m per quarter. This figure will alter if there are large numbers of retirements in the employing authorities. It is anticipated, however, that the actual figure will not be materially different to the forecast since the position of the County Council, being the largest employer in the Fund, has been taken into account.

- Payable Paysheets are forecast on the basis of the last year's profile, adjusted for known one-offs, although this can be the most volatile figure as it includes payments of lump sums and fees to Managers. This assumption errs on the side of prudence, in that this is an average figure taken from previous quarterly payments.

13. This is an early indication of the likely impact on the Pension Fund's cash flow forecast over the next 12 months. It will continue to be reviewed each quarter and refined to take into account new information as it becomes available.

Fund Rebalancing

14. Fund rebalancing is the mechanism by which the Pension Fund ensures that the asset allocation to Investment Managers is maintained at the levels agreed by the Pension Fund Committee and set out in the Statement of Investment Principles.

15. There was a rebalancing of the Fund for the period to 30 September 2015 and this took place on 12 October.

16. There will be no rebalancing of the Fund this quarter as the Fund's performance and value figures are not yet available from JP Morgan, the Global Custodian, due to a technical issue at JP Morgan.

Recommendation

17. Members are asked to note the information contained in this report.

Contact: Hilary Appleton Tel: 03000 266239

Appendix 1

Cash Flow – Estimated and Actual for the period 31 December 2015 to 31 December 2016

Quarter Ended	**31.12.14**		**31.03.15**		**30.06.15**		**30.09.15**		**30.12.15**
(1)	**Estimate** (2)	**Actual** (3)	**Estimate** (4)	**Actual** (5)	**Estimate** (6)	**Actual** (7)	**Estimate** (8)	**Actual** (9)	**Estimate** (10)
	£	£	£	£	£	£			£
Income									
Contributions - DCC	16,500,000	16,350,731	16,400,000	16,780,619	16,800,000	16,774,877	16,800,000	16,584,386	16,800,000
Contributions - Other	7,400,000	7,616,148	7,400,000	7,411,292	7,400,000	14,475,496	7,400,000	8,202,546	7,500,000
Pensions Increase	1,200,000	1,273,523	1,200,000	1,242,761	1,200,000	1,236,045	1,200,000	1,137,723	1,130,000
Transfer Values	500,000	487,359	500,000	323,361	300,000	1,135,147	500,000	272,978	500,000
Other income	500,000	2,000	10,000	265,586	250,000	922,512	250,000	1,125,117	250,000
Money recovered from Managers	0	-35,000,000						15,443,676	
Interest on short term investments	11,000	31,293	30,000	60,268	40,000	60,448	60,000	68,835	60,000
Total Income	26,111,000	-9,238,946	25,540,000	26,083,887	25,990,000	34,604,525	26,210,000	42,835,261	26,240,000
Expenditure									
Payroll Paysheets	22,000,000	22,150,713	22,200,000	22,084,713	22,300,000	18,712,769	22,300,000	26,371,670	22,400,000
Payables Paysheets (incl. Managers' fees)	7,000,000	7,134,963	7,000,000	5,972,281	9,000,000	8,776,056	10,000,000	11,571,152	7,000,000
Total Expenditure	29,000,000	29,285,676	29,200,000	28,056,994	31,300,000	27,488,825	32,300,000	37,942,822	29,400,000
Surplus / (-) Deficit	-2,889,000	-38,524,622	-3,660,000	-1,973,107	-5,310,000	7,115,700	-6,090,000	4,892,439	-3,160,000

Balance at Bank (opening)		24,421,753		56,156,417		54,689,000		58,322,978	
Balance at Bank (closing)		56,167,417		54,689,000		58,322,978		69,590,581	

Projected Cash Flow – including forecasted dividends receivable by Fund Managers for the period 31 December 2015 to 31 December 2016

Quarter Ended	**31.12.15**	**31.03.16**	**30.06.16**	**30.09.16**	**30.12.16**
	Estimate	**Estimate**	**Estimate**	**Estimate**	**Estimate**
	£	**£**	**£**	**£**	**£**
Income					
Contributions - DCC	16,800,000	16,800,000	16,800,000	16,800,000	16,800,000
Contributions - Other	7,500,000	7,400,000	7,400,000	7,400,000	7,400,000
Pensions Increase	1,130,000	1,130,000	1,130,000	1,130,000	1,130,000
Transfer Values	500,000	500,000	500,000	500,000	500,000
Other income	250,000	250,000	250,000	250,000	250,000
Gross Dividend and Interest	60,000	50,000	30,000	30,000	30,000
Total Income	26,240,000	26,130,000	26,110,000	26,110,000	26,110,000
Payroll Paysheets	22,400,000	22,500,000	22,600,000	22,700,000	22,800,000
Payables Paysheets (incl. Managers' fees)	7,000,000	8,000,000	8,000,000	8,000,000	8,000,000
Total Expenditure	29,400,000	30,500,000	30,600,000	30,700,000	30,800,000
Surplus / (-) Deficit	-3,160,000	-4,370,000	-4,490,000	-4,590,000	-4,690,000
Dividends Received by Managers	5,400,000	6,300,000	10,200,000	8,100,000	5,400,000
Net Cash Flow Position	2,240,000	1,930,000	5,710,000	3,510,000	710,000

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Pension Fund Committee

15 December 2015

Short Term Investments for the period ended 30 September 2015

Don McLure, Corporate Director Resources

Purpose of Report

1. To provide the Committee with information on the performance of the Pension Fund's short term investments as at 30 September 2015.

Short Term Investments

2. Durham County Council (DCC) invests the short term cash balances on behalf of the Pension Fund; this is done in line with DCC's Treasury Management Policy and Annual Investment Strategy. This investment strategy sets out the maximum amounts and time limits in respect of deposits which can be placed with each financial institution.

3. The Pension Fund's surplus cash holding as at 30 September 2015 was £69.584m which was held in the institutions listed in the table below alongside their credit rating at 30 September 2015.

Financial Institution	Short-term Rating	Amount Invested £m
Bank Deposit Accounts		
Handelsbanken	F1+	5.000
Santander UK Plc	F1	7.944
Barclays	F1	3.405
Fixed Term Deposits		
Barclays	F1	4.540
Bank of Scotland	F1	13.619
Nationwide Building Society	F1	7.944
Goldman Sachs	F1	7.944
Natwest	F2	4.540
National Savings & Investments	N/A	0.227
Money Market Funds	N/A	19.417
Total		**69.584**

4. The following table provides information on the net interest earned during the three month period to 30 September 2015, the average daily investment balance and the average return earned in comparison to the average bank base rate. The interest paid to the Pension Fund is based on the London Interbank Bid (LIBID) three month rate and is net of the fees of £2,500 paid for the Council undertaking the Treasury Management function for the Pension Fund.

	Total
Net Interest Earned	£70,908
Average Return Earned	0.46%
Average Bank of England base rate	0.50%
Average Daily Balance of Investments	£63.378m

Recommendation

5. Members are asked to note the position at 30 September 2015 regarding the Pension Fund's short term investments where £70,908 net interest was earned in the three month period.

Contact: Hilary Appleton Tel: 03000 266239

Agenda Item 8

Pension Fund Committee

15 December 2015

Internal Audit Progress Report to 30 September 2015

Report of Paul Bradley, Chief Internal Auditor & Corporate Fraud Manager

Purpose of the report

1 To outline progress made in delivering the 2015/16 internal audit plan relevant to the Pension Fund Committee including:

- Provide a high level of assurance, or otherwise, on internal control systems operated in the areas that have been subject to audit;
- Advise on any significant issues where controls need to improve in order to effectively manage risks;
- Advise of any other types of audit work carried out, such as consultancy reviews where an assurance opinion on the control environment may not be applicable;
- Advise of any unplanned work carried out or due to be carried out and any changes to the audit process.

Progress against 2015/16 planned work

2 A summary of the approved audit plan, with the status of each audit, is shown below:

Audit Title	Audit Type	Status	Opinion
Audits b/f from 2014/15			
Transfer payments into and out of the Pension Fund	Assurance	Final	Moderate
Governance arrangements around the Pension Fund Committee and Pension Fund Board	Assurance	Final	Moderate
2015/16 audits			
ICT controls, data quality & performance	Assurance	Final	Moderate
Payroll and Pensions	Assurance	Preparation	
Investments	Assurance	Preparation	
Accuracy and completeness of employer and employee contributions	Assurance	Preparation	
Bank Reconciliation	Assurance	Preparation	
Debt Recovery (Follow up to 2014/15 review)	Assurance	In Progress	
National Fraud Initiative – Data matching to identify potential error/fraud	Advice/Consultancy	In Progress	
Project Board – Phase two of implementation of Pension Management System (web based)	Advice/Consultancy	Not started	

3 The status shows that, of the eight assurance reviews planned to be completed in 2015/16, three final reports have been issued, of which two were issued in the quarter ending 30 September 2015.

4 A summary of the two final reports issued in the last quarter is given below:

Audit Area	Brief Scope	Assurance Opinion
Governance arrangements around the Pension Fund Committee and Pension Fund Board	Assurance review of the arrangements in place to mitigate against the risks of; - Governance failures lead to a financial underperformance or poor publicity - Pension Fund Board is not set up in accordance with legislation	Moderate
ICT controls, data quality & performance	Assurance review of the arrangements in place to mitigate against the risks of; - Users have unauthorised access to system and data - Data/information is lost - Source data is input into the system incorrectly - Poor performance goes undetected and therefore is not addressed	Moderate

Recommendation

5 Members are asked to note the work undertaken by Internal Audit during the period ending 30 September 2015 and the assurance on the control environment provided.

Contact: Paul Monaghan Tel: 03000 269662

Appendix 1: Implications

Finance

None

Staffing

None

Risk

None

Equality and Diversity/Public Sector Equality Duty

None

Accommodation

None

Crime and disorder

None

Human rights

None

Consultation

None

Procurement

None

Disability Issues

None

Legal Implications

None

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Agenda Item 9

Pension Fund Committee

15 December 2015

Local Government Pension Scheme Investment Regulations

Report of Don McLure, Corporate Director Resources

Purpose of the report

1 To provide Members with information on the Government's consultation on the revocation and replacement of the Local Government Pension Scheme (Investment and Management of Funds) Regulations 2009 (the 2009 Investment Regulations).

Background

2 The 2009 Investment Regulations detail the ways that the administering authorities for Local Government Pension Scheme (LGPS) funds must manage and invest those funds. The regulations are detailed and prescriptive, for example setting out how and under what terms investment managers should be appointed and their performance monitored, as well as listing types of permissible investments and limits on what proportions of a fund can be allocated to particular assets or asset classes.

3 As part of its Autumn Statement on 25 November 2015, the Government published a consultation document setting out proposals to revoke and replace the 2009 Investment Regulations with the draft Local Government Pension Scheme (Investment and Management of Funds) Regulations 2016 (the 2016 Investment Regulations). A copy of the consultation document and draft regulations are enclosed at Appendix A.

4 The two stated proposals of the consultation are

- Deregulating and adopting a local approach to investment – mainly to allow LGPS Funds to pool their investments and access the benefits of economies of scale; and
- Introducing a safeguard – Secretary of State power of intervention – partly to ensure all LGPS Funds will comply with the pooling requirement.

More detail on these proposals is set out below.

Proposal 1: Adopting a local approach to investment

5 Much of the detailed regulation on the types of assets that can be invested in and the proportions of investment has been removed from the draft 2016 Investment Regulations. The overall approach is to move towards a more "prudent person" approach which will align the LGPS with other major funded

pension schemes, and to move away from detailed prescription on asset classes and proportions that can be invested in them.

6 Some of the regulations that will be removed under the proposals include:

- Reference to stock-lending – on the basis that no specific reference is needed if stock-lending falls within the ordinary meaning of an "investment";
- The requirement for funds to be managed by "an adequate number" of investment managers – on the basis that administering authorities should be responsible for managing their own affairs and making these types of decisions based on prudent and proper advice;
- Conditions relating to the appointment of investment managers. The proposal is that these issues should be governed by the contracts under which the investment managers are appointed;
- The requirement for administering authorities to state the extent to which they comply with the 'Myners principles' on investment decision making. Authorities will still need to have regard to these principles but will no longer need to report against them.

7 The requirement to publish a Statement of Investment Principles will be replaced by a requirement to prepare, having taken proper advice, and publish an Investment Strategy Statement, which will cover:

- A requirement to use a wide variety of investments;
- The authority's assessment of the suitability of particular investments and types of investments;
- The authority's approach to risk, including how it will be measured and managed;
- The authority's approach to collaborative investment, including the use of collective investment vehicles and shared services;
- The authority's environmental, social and corporate governance policy;
- The authority's policy on the exercise of rights, including voting rights, attached to its investments.

8 The consultation also includes a section on "non-financial factors" and how issues such as environmental, social and corporate governance factors should or should not be taken into account when making investment decisions. This section includes reference to clarification from the Secretary of State that "*using pensions and procurement policies to pursue boycotts, divestments and sanctions against foreign nations and the UK defence industry are inappropriate, other than where formal legal sanctions, embargoes and restrictions have been but in place by the Government*." Further reference is made to the importance of ensuring the predominant concern of administering authorities when formulating a policy on environmental, social and corporate governance issues should be the pursuit of a financial return on investments, and that administering authorities should not pursue policies that "*run contrary to UK foreign policy*".

Proposal 2: Introducing a safeguard – Secretary of State Power of Intervention

9 The draft regulations give the Secretary of State the power to intervene in the investment function of an administering authority if the Secretary of State

determines that the administering authority has failed to have regard to the investment regulations or statutory guidance issued under the regulations.

10 Examples are given of where such an intervention could be necessary, including:

- Where an authority ignores information on best practice, such as advice provided by the scheme advisory board to local pension boards;
- Where an authority fails to follow statutory investment guidance, for example, by not participating in a large asset pool with other Funds as described in the draft guidance;
- Where there is evidence that an authority is carrying out a pension-related function poorly, such as failing to carry out an actuarial valuation in accordance with the regulations.

The sort of interventions that the Secretary of State could impose include:

- Requiring and administering authority to develop a new investment strategy that is compliant with the regulations;
- Directing an administering authority to invest some or all of its assets in a way that more closely matches the guidance – for example through a pooled vehicle;
- Requiring that the investment function of the administering authority are exercised by the Secretary of State or his nominee.

11 The consultation document outlines a process covering implementation of any intervention including details of notification, monitoring and review.

12 Consultation responses are requested by 19 February 2016.

Recommendation

13 Members are asked to agree that the Corporate Director Resources in consultation with the Chairman and Vice Chairman responds to the consultation after taking advice from the investment advisors.

Contact: Nick Orton Tel: 03000 269798

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Department for
Communities and
Local Government

Local Government Pension Scheme: Revoking and replacing the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009

Consultation

November 2015
Department for Communities and Local Government

This document/publication is also available on our website at www.gov.uk/dclg

If you have any enquiries regarding this document/publication, complete the form at http://forms.communities.gov.uk/ or write to us at:

Department for Communities and Local Government
Fry Building
2 Marsham Street
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SW1P 4DF
Telephone: 030 3444 0000

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November 2015

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Contents

About this consultation

This consultation document and consultation process have been planned to adhere to the Consultation Principles issued by the Cabinet Office.

Representative groups are asked to give a summary of the people and organisations they represent, and where relevant who else they have consulted in reaching their conclusions when they respond.

Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004.

If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals, amongst other things, with obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on the Department.

The Department for Communities and Local Government will process your personal data in accordance with DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

Individual responses will not be acknowledged unless specifically requested.

Your opinions are valuable to us. Thank you for taking the time to read this document and respond.

Are you satisfied that this consultation has followed the Consultation Principles? If not or you have any other observations about how we can improve the process please contact DCLG Consultation Co-ordinator.

Department for Communities and Local Government

2 Marsham Street

London

SW1P 4DF

or by e-mail to: consultationcoordinator@communities.gsi.gov.uk

The consultation process and how to respond

Scope of the consultation

Topic of this consultation:	This consultation proposes to revoke and replace the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 with the draft regulations described in this paper. There are two main areas of reform: 1. A package of reforms that propose to remove some of the existing prescribed means of securing a diversified investment strategy and instead place the onus on authorities to determine the balance of their investments and take account of risk. 2. The introduction of safeguards to ensure that the more flexible legislation proposed is used appropriately and that the guidance on pooling assets is adhered to. This includes a suggested power to allow the Secretary of State to intervene in the investment function of an administering authority when necessary.
Scope of this consultation:	Views are sought on: 1. Whether the proposed revisions to the investment regulations will give authorities the flexibility to determine a suitable investment strategy that appropriately takes account of risk. 2. Whether the proposals to introduce the power of intervention as a safeguard will enable the Secretary of State to intervene, when appropriate, to ensure that authorities take advantage of the benefits of scale offered by pooling and deliver investment strategies that adhere to regulation and guidance.
Geographical scope:	This consultation applies to England and Wales.
Impact Assessment:	The proposed interventions affect the investment of assets by local government pension scheme administering authorities. These authorities are all public sector organisations, so no impact assessment is required.

Basic Information

To:	The consultation is aimed at all parties with an interest in the Local Government Pension Scheme (the Scheme) and in particular those listed on the Government's website: https://www.gov.uk/government/publications/local-government-pension-scheme-regulations-information-on-who-should-be-consulted
Body/bodies responsible for the consultation:	Secretary of State, Department for Communities and Local Government. The consultation will be administered by the Workforce, Pay and Pensions Division.
Duration:	25 November 2015 to 19 February 2016
Enquiries:	Enquires should be sent to Victoria Edwards. Please email LGPSReform@communities.gsi.gov.uk or call 0303 444 4057.
How to respond:	Responses to this consultation should be submitted to LGPSReform@communities.gsi.gov.uk by **19 February 2016**. Electronic responses are preferred. However, you can also write to: LGPS Reform Department for Communities and Local Government 2/SE Quarter, Fry Building 2 Marsham Street London SW1P 4DF
Additional ways to become involved:	If you would like to discuss the proposals, please email LGPSReform@communities.gsi.gov.uk
After the consultation:	All consultation responses will be reviewed and analysed. A Government response will then be published within three months, and subject to the outcome of this consultation, the resulting regulations laid in Parliament.
Compatibility with the Consultation Principles:	This consultation has been drafted in accordance with the Consultation Principles.

Background

Getting to this stage:	The proposals in this consultation are the culmination of work looking into Local Government Pension Scheme investments that began in early 2013. It has been developed in response to the May 2014 consultation, *Opportunities for collaboration, cost savings and efficiencies,* which considered whether savings might be delivered through collective investment and greater use of passive fund management. A copy of the consultation and the Government's response is available on the Government's website: https://www.gov.uk/government/consultations/local-government-pension-scheme-opportunities-for-collaboration-cost-savings-and-efficiencies. The consultation responses called for a voluntary approach to reform, opposing the introduction of a single, national model of pooling. The Government has therefore invited authorities to develop their own proposals for pooling, subject to common criteria and guidance. The criteria for reform have been developed using the consultation responses and following a series of workshops and conversations with authorities and the fund management industry since the July Budget 2015. Some respondents to the May 2014 consultation also suggested that amendments were required to the investment regulations in order to facilitate greater investment in pooled vehicles. In addition, prior to that consultation, authorities and the fund management industry had called for wider reform. A small working group, whose participants are listed in Annex A, was established to look at whether the approach to risk management and diversification in the existing regulations was still appropriate. They recommended moving towards the "prudential person" approach that governs trust based pension schemes. The group also sought clarity as to whether certain types of investment were possible, such as the use of derivatives in risk management. The work of that group has informed the development of this consultation. In relaxing the regulatory framework for scheme investments, it is important to introduce safeguards to ensure that the less prescriptive approach is used appropriately. The July Budget 2015 announcement also indicated that measures should be introduced to ensure that those authorities who do not bring forward ambitious proposals for pooling, in keeping with the criteria, should be required to pool. This consultation therefore sets out how the Secretary of State might intervene to ensure that authorities take advantage of the benefits of scale offered by pooling and deliver investment strategies that adhere to regulation and guidance.

Previous engagement:	The proposed changes in this consultation are the result of a programme of engagement that began in summer 2013: • Round table event, 16 May 2013. Representatives of administering authorities, employers, trade unions, the actuarial profession and academia discussed the potential for increased cooperation within the Scheme. • A call for evidence, run with the Local Government Association, June to September 2013. This gave anyone with an interest in the Scheme the opportunity to inform the Government's thinking on potential structural reform. The results were shared with the Shadow Scheme Advisory Board, which provided the Minister for Local Government with their analysis of the responses. • Consultation, *Opportunities for collaboration, cost savings and efficiencies,* May to June 2014. The consultation set out how savings of £470-660m a year could be achieved by collective investment and greater use of passive fund management. It also sought views as to how these reforms might best be implemented. The Government's response is available online: https://www.gov.uk/government/consultations/local-government-pension-scheme-opportunities-for-collaboration-cost-savings-and-efficiencies. • Informal engagement, July to November, 2015. Since the July Budget 2015 announcement, officials have attended over 25 workshops and bi-lateral meetings with administering authorities and the fund management industry. These discussions have been used to develop the criteria for reform and inform how the proposed power of the Secretary of State to intervene might work. In addition, the Investment Regulation Review Group was formed in 2012 to consider potential amendments to the investment regulations. The group included representatives from administering authorities, actuarial firms, pension lawyers and the fund management industry. An initial proposal for reform was prepared that has also informed the development of the draft regulations that are the subject of this consultation.

Introduction and Background

Introduction

1.1 In May 2014 the Government published a consultation which set out how savings of up to £660m a year might be achieved through greater use of passive management and pooled investment. Investing collectively can help authorities to drive down costs and access the benefits of scale, and also enables them to develop the capacity and capability to invest more cost effectively in illiquid asset classes such as infrastructure. The Government has therefore invited authorities to develop ambitious proposals for pooling assets that meet published criteria. More information about the criteria and process of reform is available on the Government's website: https://www.gov.uk/government/publications/local-government-pension-scheme-investment-reform-criteria-and-guidance.

1.2 This consultation complements that invitation, recognising that the existing regulations place restrictions on certain investments that may constrain authorities considering how best to pool their assets. It therefore proposes to move to a prudential approach to securing a diversified investment strategy that appropriately takes account of risk. In so doing, and to ensure that authorities take advantage of the benefits of scale, the Government proposes to introduce a power to allow the Secretary of State to intervene to ensure that authorities take advantage of the benefits of scale offered by pooling and deliver investment strategies that adhere to regulation and guidance.

1.3 This paper sets out the purpose and rationale of the suggested amendments to the investment regulations, and seeks views as to whether the proposed approach would best deliver those stated aims.

Background

1.4 With assets of £178bn at its last valuation on 31 March 2013, the Local Government Pension Scheme is one of the largest funded pension schemes in Europe. Several thousand employers participate in the Scheme, which has a total of 4.68 million active, deferred and pensioner members.[1] The Department for Communities and Local Government is responsible for the regulatory framework governing the Scheme in England and Wales.

1.5 The Scheme is managed through 90 administering authorities which broadly correspond to the county councils following the 1974 local government reorganisation as well as each of the 33 London boroughs. In most cases, the administering authorities are upper tier local authorities such as county or unitary councils, but there are also some authorities established specifically to manage their pension liabilities, for example the London Pension Fund Authority and the Environment Agency Pension Fund. The

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[1] Scheme asset value and membership figures taken from Department for Communities and Local Government statistical data set - Local government pension scheme funds summary data: 2012 to 2013 https://www.gov.uk/government/statistical-data-sets/local-government-pension-scheme-funds-summary-data-2012-to-2013

administering authorities have individual governance and working arrangements. Each has its own funding level, cash-flow and balance of active, deferred and pensioner members. Authorities take these circumstances into account when preparing their investment strategies, which are normally agreed by the councillors on each authority's pension committee. The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 set the legal framework for the development of these investment strategies and the investments carried out by administering authorities. This consultation proposes that the Government revokes and replaces those regulations.

1.6 Under the Public Service Pensions Act 2013, there is a requirement for a national scheme advisory board, as well as a local board for each of the 90 funds. In 2013, Scheme employers and the trade unions established a shadow board, which has been considering a number of issues connected with the Scheme, including its efficient management and administration. Appointments have now been made to the national scheme advisory board and the Chair is expected to be appointed shortly.

Getting to this stage

2.1 The consultation is formed of two main proposals:

1. A package of reforms that propose to remove some the existing prescribed means of securing a diversified investment strategy and instead place the onus on authorities to determine the balance of their investments and take account of risk. The changes proposed would move towards the “prudent person” approach to investment that applies to trust based pension schemes.
2. The introduction of safeguards to ensure that the more flexible legislation proposed is used appropriately, and that the guidance on pooling assets is adhered to, including a power to allow the Secretary of State to intervene in the investment function of an administering authority when necessary.

Pooling assets to deliver the benefits of scale

2.2 The proposals set out in this consultation are the culmination of work carried out over the last two and a half years to explore how to reform the way the Scheme makes its investments in order to achieve the benefits of scale and drive efficiencies.

2.3 In summer 2013, the coalition government launched a call for evidence to explore how the Scheme might be made more sustainable and affordable in the long term. 133 responses were received, many of which took the opportunity to discuss whether collective investment and greater collaboration might deliver savings for the Scheme.

2.4 Following the call for evidence, the Minister for the Cabinet Office and Minister for Local Government commissioned a cost-benefits analysis from Hymans Robertson on a range of proposals. Hymans Robertson’s report explored three areas:

- **The cost of investment:** Many of the costs associated with investment are not transparent and so difficult to capture. The costs of managing and administering the Scheme were reported as being £536 million in 2012-13.[2] However, Hymans Robertson found that the actual cost was likely to be rather higher; with investment costs alone estimated as in excess of £790 million a year.[3]
- **Approaches to collaboration:** Hymans Robertson was asked to examine the costs and benefits of three options for reform: merging the authorities into 5-10 funds, creating 5-10 collective investment vehicles, or establishing just 1-2 collective investment vehicles. They found that the net present value of savings over ten years was highest with a small number of vehicles, while merging funds offered the lowest benefit.[4]

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[2] Local government pension scheme funds summary data: 2012 to 2013
[3] Department for Communities and Local Government: Local Government Pension Scheme structure analysis, Hymans Robertson pp. 10-11. https://www.gov.uk/government/consultations/local-government-pension-scheme-opportunities-for-collaboration-cost-savings-and-efficiencies
[4] Hymans Robertson, p.6

- **The aggregate performance of the scheme:** The report found that the Scheme as a whole had been achieving the market rate of return in each of the main equity markets over the ten years to March 2013. If the Scheme's investments in bonds and equities had been managed passively instead of actively, authorities could have saved at least £230m a year in management fees without affecting overall investment returns.[5]

2.5 Drawing on the Hymans Robertson report and the call for evidence, the coalition government published a consultation in May 2014 entitled *Opportunities for collaboration, cost savings and efficiencies*. This set out how the Scheme could save up to £660m a year by using collective investment vehicles and making greater use of passive management for listed assets like bonds and equities. The consultation sought views on these proposals, and how they might be most effectively implemented. Respondents were broadly in favour of pooling assets, but felt that any reform should be voluntary and led by administering authorities. While many recognised a role for passive management in an investment strategy, most also felt that some active management should be retained.

2.6 At the July Budget 2015, Ministers having reflected on the consultation responses, the Chancellor announced the Government's intention to invite administering authorities to bring forward proposals for pooling local government pension scheme investments. Authorities' proposals would be assessed against published criteria, designed to encourage ambition in the pursuit of efficiencies and the benefits of scale. These criteria have now been published and are available online at https://www.gov.uk/government/publications/local-government-pension-scheme-investment-reform-criteria-and-guidance.

Updating the investment regulations

2.7 When considering the implications of creating asset pools amongst authorities, some respondents to the May 2014 consultation took the opportunity to call for a review of the existing investment regulations. At their introduction in 2009, the regulations sought to ensure that authorities established a balanced and diversified portfolio by placing restrictions on the proportion of their assets that could be invested in different vehicles. For example, deposits with a single bank, institution or person, (other than the National Savings Bank), were restricted to 10% of an authority's assets. These restrictions have been kept under regular review and have been subject to change following representations from the investment sector and pension fund authorities.

2.8 Some respondents to the consultation suggested that the current limits on investments would prevent authorities from making meaningful allocations to a collective investment vehicle, one of the leading options for asset pooling, as the allocation to particular types of vehicle is capped at 35%. Participants in the London Boroughs' collective investment vehicle and the collaboration between the London Pension Fund Authority and Lancashire County Council also wrote to the Department encouraging reform in this area.

[5] Hymans Robertson, p.12

2.9 While the proposals for collective investment in the May 2014 consultation prompted encouragement to review the investment regulations, the idea of reform was not new. In 2012, following representations from the investment sector, the Government formed a small working group to revisit and examine the investment regulations with input from actuaries, fund managers and administering authorities. This group, whose membership is set out in Annex A, recommended that a more permissive approach should be taken to the legislative framework, similar to the “prudent person” model that applies to trust based pension schemes. This approach places the onus on the pension fund to determine a suitable balance of investments to meet its liabilities, which are clearly articulated in an investment strategy. The group also felt that the existing regulations introduced uncertainty for some authorities as to what constituted a permitted investment, as some asset classes were explicitly referenced but others were not. In particular, concern has been expressed as to whether or not pension fund authorities are permitted to invest in vehicles such as derivatives, hedge funds and forward currency contracts.

2.10 The proposals in this consultation paper therefore seek to address these issues, placing the onus on authorities to determine a diversified investment strategy that appropriately takes risk into account.

2.11 However, in relaxing the regulatory framework for scheme investments, it is also important to introduce safeguards to ensure that the less prescriptive approach proposed is used appropriately. Similarly, the July Budget 2015 announcement stated that draft regulations would be introduced to require an authority to pool its investments if it did not bring forward ambitious proposals that met the Government’s criteria. This consultation therefore sets out how the Secretary of State might intervene to ensure that authorities take advantage of the benefits of scale offered by pooling and deliver investment strategies that adhere to regulation and guidance.

Response to the Law Commission’s Review of Fiduciary Duty

2.12 The Kay Review on Fiduciary Duty published its final report in July 2012. In addition to making a number of recommendations to address the excessive focus on short-term performance in equity investment markets, it recommended that the Government ask the Law Commission to review the fiduciary duties of investment intermediaries amid concerns that these common law duties were being interpreted by some pension schemes as a requirement to focus solely on short-term financial returns.

2.13 In their report, published in July 2014, the Law Commission called on the Department to review:

- Whether the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 should transpose article 18(1) of the Institutions for Occupational Retirement Provision (IORP) Directive, and
- Those aspects of Regulation 9 of the 2009 Regulations which require investment managers to be appointed on a short-term basis and reviewed every three months.

2.14 These recommendations were supported by the Government's progress report on the implementation of the Kay Review published in October 2014 by the Department for Business Innovation and Skills.

2.15 Article 18(1) of the IORP Directive requires assets to be invested in the best interests of members and beneficiaries and, in the event of a conflict of interest, in the sole interests of members and beneficiaries.

2.16 Regulation 4 of The Occupational Pension Schemes (Investment) Regulations 2005 (SI 2005 No 3378) transposed Article 18(1):

"4. (1) The trustees of a trust scheme must exercise their powers of investment, and any fund manager to whom any discretion has been delegated under section 34 of the 1995 Act (power of investment and delegation) must exercise the discretion, in accordance with the following provisions of this regulation

(2) The assets must be invested:

(a) In the best interests of members and beneficiaries; and

(b) In the case of a potential conflict of interest, in the sole interest of members and beneficiaries."

2.17 The Local Government Pension Scheme is a statutory scheme made under section 1 of the Public Service Pensions Act 2013 and previously under The Superannuation Act 1972. It is not subject to trust law and those responsible for making investment decisions in the Scheme are not therefore required to comply with Regulation 4 of the 2005 Regulations.

2.18 However, this does nothing to change the general legal principles governing the administration of Scheme investments and how those responsible for such decisions should exercise their duties and powers under the Scheme's investment regulations.

2.19 In a circular issued by the then Department of the Environment in 1983 (No 24), the Secretary of State took the view that administering authorities should pay due regard to the principle contained in the case of Roberts v Hopwood [1925] A.C. 578 p. 595:

"A body charged with the administration for definite purposes of funds contributed in whole or in part by persons other than members of that body owes, in my view, a duty to those latter persons to conduct that administration in a fairly business-like manner with reasonable care, skill and caution, and with a due and alert regard to the interest of those contributors who are not members of the body. Towards these latter persons, the body stands somewhat in the position of trustees or managers of the property of others."

2.20 Those in local government responsible for making investment decisions must also act in accordance with ordinary public law principles, in particular, the ordinary public law principles of reasonableness. They risk challenge if a decision they make is so unreasonable that no reasonable person acting reasonably could have made it.

2.21 Having considered fully the recommendation made by the Kay Review and supported by both the Law Commission and the Government, Ministers are satisfied that the Scheme is consistent with the national legislative framework governing the duties placed on those responsible for making investment decisions. The position at common law is also indistinguishable from that produced by the 2005 Regulations applicable in respect of trust-based schemes.

2.22 We do, however, propose to remove the requirement for the performance of investment managers to be reviewed once every three months from the regulations.

Proposal 1: Adopting a local approach to investment

Deregulating and adopting a local approach to investment

3.1 In developing these draft regulations, the Government has sought, where appropriate, to deregulate and simplify the regulations that have governed the management and investment of funds since 2009. Some of the existing provisions have not been carried forward into the draft 2016 Regulations in the expectation that they would be effectively maintained by general law provisions and so specific regulation is no longer needed. For example, those making investment decisions are still required to act prudently, and there remains a statutory requirement to take and act on proper advice. Some of the provisions in the 2009 Regulations which have not been carried forward on this basis include:

- Stock lending arrangements under Regulation 3(8) and (9) of the 2009 regulations. The view is taken that the definition of "investment" in draft Regulation 3 is sufficient given that a stock lending arrangement can only be used if it falls within the ordinary meaning of an "investment".
- Regulation 8(5) of the 2009 regulations ensures that funds are managed by an adequate number of investment managers and that, where there is more than one investment manager, the value of the fund money managed by them is not disproportionate. Here, the view is taken that administering authorities should be responsible for managing their own affairs and making decisions of this kind based on prudent and proper advice.
- There are many provisions in the 2009 Regulations which impose conditions on the choice and terms of appointments of investment managers. Since the activities of investment managers are governed by the contracts under which they are appointed, the view is taken that making similar provision in the 2016 Regulations would be unnecessary duplication. Examples include the requirement for investment managers to comply with an administering authority's instructions and the power to terminate the appointment by not more than one month's notice.
- Regulation 12(3) of the 2009 Regulations requires administering authorities to state the extent to which they comply with guidance given by the Secretary of State on the Myners principles for investment decision making. As part of the wider deregulation, the draft regulations make no provision to report against these principles, although authorities should still have regard to the guidance.

3.2 These examples of deregulation are for illustrative purposes only. It is not an exhaustive list of provisions which the Government proposes to remove. Consultees are asked to look carefully at the full extent of deregulation and comment on any particular case that raises concerns about the impact such an omission might have on the effective management and investment of funds.

Investment strategy statement

3.3 As part of this deregulation, the draft regulations also propose to remove the existing schedule of limitations on investments. Instead authorities will be expected to take a prudential approach, demonstrating that they have given consideration to the suitability of different types of investment, have ensured an appropriately diverse portfolio of assets and have ensured an appropriate approach to managing risk.

3.4 Key to this will be the investment strategy statement, which authorities will be required to prepare, having taken proper advice, and publish. The statement must cover:

- A requirement to use a wide variety of investments.
- The authority's assessment of the suitability of particular investments and types of investments.
- The authority's approach to risk, including how it will be measured and managed.
- The authority's approach to collaborative investment, including the use of collective investment vehicles and shared services.
- The authority's environmental, social and corporate governance policy.
- The authority's policy on the exercise of rights, including voting rights, attached to its investments.

Transitional arrangements

3.5 Draft regulation seven proposes to require authorities to publish an investment strategy statement no later than six months after the regulations come into force (this is currently drafted as 1 October 2016, in case the draft regulations come into effect on 1 April 2016). However, the draft regulations would also revoke the existing 2009 Regulations when they come into effect. Transitional arrangements are therefore required to ensure that an authority's investments and investment strategy are regulated between the draft regulations coming into effect and the publication of an authority's new investment strategy statement. The transitional arrangements proposed in draft regulation 12 would mean that the following regulations in the 2009 Regulations would remain in place until the authority publishes an investment strategy or six months lapses from the date that the regulations come into effect:

- 11 (investment policy and investment of pension fund money)
- 14 (restrictions on investments)
- 15 (requirements for increased limits)
- Schedule 1 (table of limits on investments)

Statement of Investment Principles

3.6 We do not propose to carry forward the existing requirement under regulation 12 of the 2009 Regulations to maintain a Statement of Investment Principles. However, the main elements, such as risk, diversification, corporate governance and suitability, will instead be carried forward as part of the reporting requirements of the new investment strategy statement. Administering authorities will still be required to maintain their funding strategy statements under Regulation 58 of the 2013 regulations.

Non-financial factors

3.7 The Secretary of State has made clear that using pensions and procurement policies to pursue boycotts, divestments and sanctions against foreign nations and the UK defence industry are inappropriate, other than where formal legal sanctions, embargoes and restrictions have been put in place by the Government. The Secretary of State has said, “Divisive policies undermine good community relations, and harm the economic security of families by pushing up council tax. We need to challenge and prevent the politics of division.”

3.8 The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 already require administering authorities to publish and follow a statement of investment principles, which must comply with guidance issued by the Secretary of State. The draft replacement Regulations include provision for administering authorities to publish their policies on the extent to which environmental, social and corporate governance matters are taken into account in the selection, retention and realisation of investments. Guidance on how these policies should reflect foreign policy and related issues will be published ahead of the new Regulations coming into force. This will make clear to authorities that in formulating these policies their predominant concern should be the pursuit of a financial return on their investments, including over the longer term, and that, reflecting the position set out in the paragraph above, they should not pursue policies which run contrary to UK foreign policy.

Investment

3.9 A few definitions and some aspects of regulation 3, which describes what constitutes an investment for the purpose of these regulations, have been updated to take account of changing terminology and technical changes since the regulations were last issued in 2009. For example, the reference to the London International Financial Futures Exchange (LIFFE) has been removed as it now operates as a clearing house and so is covered by the approved stock exchange definition.

3.10 Some additional information has been included to make clear that certain investments, such as derivatives, may be used where appropriate. The Government expects that having considered the appropriateness of an investment in their investment strategy statement, authorities would only use derivatives as a means of managing risk, and so has not explicitly stated that this should be the case.

Questions

1. Does the proposed deregulation achieve the intended policy aim of removing any unnecessary regulation while still ensuring that authorities’ investments are made prudently and having taken advice?

2. Are there any specific issues that should be reinstated? Please explain why.

3. Is six months the appropriate period for the transitional arrangements to remain in place?

4. Should the regulation be explicit that derivatives should only be used as a risk management tool? Are there any other circumstances in which the use of derivatives would be appropriate?

Proposal 2: Introducing a safeguard - Secretary of State power of intervention

Summary of the proposal

4.1 The first part of this consultation lifts some of the existing restrictions on administering authorities' investments in order to make it easier for them to pool their investments and access the benefits of scale. To ensure that this new flexibility is used appropriately, the consultation also proposes to introduce a power to intervene in the investment function of an administering authority if the Secretary of State believes that it has not had regard to guidance and regulations. The consultation sets out the evidence that the Secretary of State may draw on before deciding to intervene, and makes clear that any direction will need to be proportionate. The power proposed in this consultation is intended to allow the Secretary of State to act if best practice or regulation is being ignored, which will help to ensure that authorities continue to pursue more efficient means of investment.

4.2 The July Budget 2015 announcement set out the Government's intention to introduce "backstop" legislation to require those authorities who do not bring forward sufficiently ambitious plans to pool their investments. It also explained that authorities' proposals would need to meet common criteria, which have been published with draft guidance alongside this consultation. The draft power to intervene discussed in this paper could be used to address authorities that do not bring forward proposals for pooling their assets in line with the published criteria and guidance. The guidance will be kept under review, and will be revised as circumstances change and authorities' asset pools evolve.

4.3 The following sections set out the process for intervention described in draft regulation 8.

Determining to intervene

4.4 The draft regulations propose to give the Secretary of State the power to intervene in the investment function an administering authority, if the Secretary of State has determined that the administering authority has failed to have regard to the regulations governing their investments or guidance issued under draft regulation 7(1). In reaching that conclusion, the Secretary of State will consider the available evidence, which might include:

- Evidence that an administering authority is ignoring information on best practice, for example, by not responding to advice provided by the scheme advisory board to local pension boards.
- Evidence that an administering authority is not following the investment regulations or has not had regard to guidance published by the Secretary of State under draft Regulation 7 (1). For example, this might include failing to participate in one of the large asset pools described in the existing draft guidance, or proposing a pooling arrangement that does not adhere to the criteria and guidance.

- Evidence that an administering authority is carrying out another pension-related function poorly, such as an unsatisfactory report under section 13(4) of the Public Service Pensions Act 2013, or another periodic reporting mechanism. (Section 13(4) of the 2013 Act requires a person appointed by the Secretary of State to report on whether the actuarial valuation of a fund has been carried out in accordance with Scheme regulations, in a way that is consistent with other authorities' valuations, and so that employer contribution rates are set to ensure the solvency and long term cost efficiency of the fund.)

4.5 If the Secretary of State has some indication to suggest that intervention might be necessary, the draft regulations propose that he may order a further investigation to provide him with the analysis required to make a decision. If additional evidence is sought, draft regulation 8(5) would allow the Secretary of State to carry out such inquiries as he considers appropriate, including seeking advice from external experts if needed. In this circumstance, the administering authority would be obliged to provide any data that was deemed necessary to determine whether intervention is required. The authority would also be invited to participate in the review and would have the opportunity to present evidence in support of its existing or proposed investment strategy.

The process of intervention

4.6 If the Secretary of State is satisfied that an intervention is required, he would then need to determine the appropriate extent of intervention in the authority's investment function. The draft regulations propose to allow the Secretary of State to draw on external advice to determine what the specific intervention should be if necessary.

4.7 Draft regulation 8(2) describes the interventions that the Secretary of State may make. The power has been left intentionally broad to ensure that a tailored and measured course of action is applied, based on the circumstances of each case. For example, in some cases it may be appropriate to apply the intervention just to certain parts of an investment strategy, whereas in particularly concerning cases, more substantial action might be required. The proposed intervention might include, but is not limited to:

- Requiring an administering authority to develop a new investment strategy statement that follows guidance published under draft Regulation 7(1).
- Directing an administering authority to invest all or a portion of its assets in a particular way that more closely adheres to the criteria and guidance, for instance through a pooled vehicle.
- Requiring that the investment functions of the administering authority are exercised by the Secretary of State or his nominee.
- Directing the implementation of the investment strategy of the administering authority to be undertaken by another body.

4.8 The Secretary of State will write to the authority outlining the proposed intervention. As a minimum, this proposal will include:

- A detailed explanation of why the Secretary of State is intervening and the evidence used to arrive at their determination.

- A clear description of the proposed intervention and how it will be implemented and monitored.
- The timetable for the intervention, including the period of time until the intervention is formally reviewed.
- The circumstances under which the intervention might be lifted prior to review.

4.9 The authority will then be given time to consider the proposal and present its argument for any changes that it thinks should be made. If, at the end of that period an intervention is issued, any resulting costs, charges and expenses incurred in administering the fund would be met by the pension fund assets.

Review

4.10 As set out above, each intervention will be subject to a formal review period which will be set by the Secretary of State but may coincide with other cyclical events such as the preparation of an annual report or a triennial valuation. At the end of that period, progress will be assessed and the Secretary of State will decide whether to end, modify or maintain the current terms of the intervention, and will notify the authority of the outcome. The authority will also have the opportunity to make representations to the Secretary of State if it feels a different course of action should be followed. Throughout this period of intervention, the authority will be supported to improve its investment function, so that it is well placed to bring the intervention to an end at the first opportunity.

4.11 The Secretary of State's direction will include details about what is required of the authority in order to end the intervention, and how progress will be measured. Progress could, for example, be measured by creating a set of performance indicators to be monitored on an ongoing basis by Government officials, the local pension board, the scheme advisory board, or an independent body. A regime of regular formal reports to the Secretary of State could also be required.

4.12 The draft regulations also allow the Secretary of State to determine that sufficient improvement has been made to end the intervention before the review date. The administering authority may also make representations to the Secretary of State before that date, if it has clear evidence that the prescribed action is no longer appropriate.

Questions

5. Are there any other sources of evidence that the Secretary of State might draw on to establish whether an intervention is required?

6. Does the intervention allow authorities sufficient scope and time to present evidence in favour of their existing arrangements when either determining an intervention in the first place, or reviewing whether one should remain in place?

7. Does the proposed approach allow the Secretary of State sufficient flexibility to ensure that he is able to introduce a proportionate intervention?

8. Do the proposals meet the objectives of the policy, which are to allow the Secretary of State to make a proportionate intervention in the investment function of an administering authority if it has not had regard to best practice, guidance or regulation?

Summary of the draft regulations

(1) Citation, commencement and extent

This details the citation and scope of the draft regulations, and gives the date at which they will come into force.

(2) Interpretation

These provisions define terms used in the draft regulations with reference to legislation, and cite the legislation that gives administering authorities the powers that may be impacted by the draft regulations.

(3) Investment

This draft regulation defines what is considered an investment for the purposes of the regulations. This definition includes futures, options, derivatives, limited partnerships and some types of insurance contracts. It also defines who a person with whom a contract of insurance can be entered into is.

(4) Management of a pension fund

This draft regulation lists the monies that an administering authority must credit to its pension fund, including employer and employee contributions, interest, and investment capital and income. It also sets out the administering authority's responsibility to pay benefits entitled to members, and states that, except where prohibited by other regulations, costs of administering the fund can be paid by the fund.

(5) Restriction on power to borrow

This proposed regulation outlines the limited circumstances under which an administering authority can borrow money that the pension fund is liable to repay.

(6) Separate bank account

The draft regulation states that an administering authority must deposit all pension fund monies in a separate account, and lists those institutions that can act as a deposit taker. It also states that the deposit taker cannot use pension fund account to set-off any other account held by the administering authority or a connected party.

(7) Investment strategy statement

This draft regulation places an obligation on the administering authority to consult on and publish an investment strategy statement, which must be in accordance with guidance from the Secretary of State. The statement should demonstrate that investments will be suitably diversified, and it should outline the administering authority's maximum allocations for different asset classes, as well as their approach to risk and responsible investing.

In many respects, the investment strategy statement replaces the list of restrictions given in Schedule 1 of the 2009 Regulations and enables the criteria to be determined at local level. Schedule 1 of the 2009 Regulations will remain in force until such time that the new investment strategy statements have to be published.

Provision is made for authorities to publish their policy on the extent to which environmental, social and corporate governance factors are taken into account in the selection, retention and realisation of investments.

Separate guidance will be issued by the Secretary of State that will clarify how the Government's recent announcement on boycotts, sanctions and disinvestment will be exercised.

(8) Directions by the Secretary of State

This provision would grant the Secretary of State the power to intervene in the investment function of an administering authority if he is satisfied that the authority is failing to have regard to regulation and guidance. He can also initiate inquiries to determine if an intervention is warranted, and must consult with the authority concerned. Once it is determined that an intervention is needed, the Secretary of State can intervene by directing the authority undertake a broad range of actoins to remedy the situation.

(9) Investment managers

This draft regulation details how an administering authority must appoint external investment managers.

(10) Investments under section 11(1) of the Trustee Investments Act 1961

This draft regulation allows administering authorities to invest in Treasury-approved collective investment schemes.

(11) Consequential amendments

This proposed regulation lists the prior regulations that are amended by the draft amendments.

(12) Revocations and transitional provisions

The draft provision lists the regulations that would be revoked if the draft regulations come into effect. It also proposes transitional arrangements to ensure that the existing regulations governing the investment strategy remain in place until a new investment strategy statement is published by an authority under draft regulation seven. These transitional arrangements would apply for up to six months after the draft regulations came into effect.

Annex A: Members of the Investment Regulation Review Group

Alison Hamilton	Barnet Waddingham
Bob Claxton	Wandsworth Pension Fund
Clifford Sims	Squire Patton Boggs
Dawn Turner	Environment Agency Pension Fund
Geoff Reader	Bedford Pension Fund
Graeme Russell	Greater Gwent Pension Fund
Guy Sears	Investment UK
Loretta Stowers	Greater Manchester Pension Fund
Nick Buckland	Dorset Pension Fund
Nigel Keogh	Chartered Institute of Public Finance and Accountancy
Paul Dale	Bromley Borough Council
Peter Morris	Greater Manchester Pension Fund

STATUTORY INSTRUMENTS

2016 No. 0000

PUBLIC SERVICE PENSIONS, ENGLAND AND WALES

The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016

Made - - - -	*2016*
Laid before Parliament	*2016*
Coming into force - -	*2016*

These Regulations are made in exercise of the powers conferred by sections 1 and 3 of, and Schedule 3 to, the Public Service Pensions Act 2013(**a**).

In accordance with section 21 of that Act, the Secretary of State has consulted such persons and the representatives of such persons as appeared to the Secretary of State to be likely to be affected by these Regulations.

In accordance with section 3(5) of that Act, these Regulations are made with the consent of the Treasury.

The Secretary of State makes the following Regulations:

Citation, commencement and extent

1.—(1) These Regulations may be cited as the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016.

(2) These Regulations come into force on 1st April 2016.

(3) These Regulations extend to England and Wales.

Interpretation

2.—(1) In these Regulations—

"the 2000 Act" means the Financial Services and Markets Act 2000(**b**);

"the 2013 Regulations" means the Local Government Pension Scheme Regulations 2013(**c**);

"the Transitional Regulations" means the Local Government Pension Scheme (Transitional Provisions, Savings and Amendment) Regulations 2014(**d**);

(**a**) 2013 c. 25
(**b**) 2000 c.8.
(**c**) S.I. 2013/2356.
(**d**) S.I. 2014/525.

"authority" means an administering authority listed in Part 1 of Schedule 3 to the 2013 Regulations;

"fund money" means money that is or should be in a pension fund maintained by an authority;

"proper advice" means the advice of a person whom the authority reasonably believes to be qualified by their ability in and practical experience of financial matters;

"the Scheme" means the scheme established by the 2013 Regulations.

(2) Any restrictions imposed by these Regulations apply to authorities which have the power within section 1 of the Localism Act 2011(**a**) (local authority's general power of competence) or section 5A(1) of the Fire and Rescue Services Act 2004(**b**) in the exercise of those powers.

(3) Any authority which does not have the powers mentioned in paragraph (2) has, by virtue of these Regulations the power to do anything authorised or required by these Regulations.

Investment

3.—(1) In these Regulations "investment" and related expressions have their normal meaning.

(2) But the following provisions of this regulation specify things which count as investments for these Regulations, although they might not otherwise do so, and exclude things which might otherwise count.

(3) A contract entered into in the course of dealing in financial futures, traded options or derivatives is an investment.

(4) A contract of insurance is an investment if it is a contract of a relevant class, and is entered into with a person within paragraph (5) for whom entering into the contract constitutes the carrying on of a regulated activity within the meaning of section 22 of the 2000 Act(**c**).

(5) The persons within this paragraph are—

(a) a person who has permission under Part 4A of the 2000 Act (permission to carry on regulated activities) to effect or carry out contracts of insurance of a relevant class;

(b) an EEA firm of the kind mentioned in paragraph 5(d) of Schedule 3 to the 2000 Act (EEA passport rights), which has permission under paragraph 15 of that Schedule(**d**) to effect or carry out contracts of insurance of a relevant class; and

(c) a person who does not fall within sub-paragraph (a) or (b) whose head office is in an EEA state other than the United Kingdom, and who is permitted by the law of that state to effect or carry out contracts of insurance of a relevant class.

(6) A contract of insurance is of a relevant class for the purposes of paragraphs (4) and (5) if it is—

(a) a contract of insurance on human life or a contract to pay an annuity on human life where the benefits are wholly or partly to be determined by reference to the value of, or income from, property of any description (whether or not specified in the contract) or by reference to fluctuations in, or an index of, the value of property of any description (whether or not so specified); or

(b) a contract to manage the investments of pension funds, whether or not combined with contracts of insurance covering either conservation of capital or payment of minimum interest.

(7) It is an investment to contribute to a limited partnership in an unquoted securities investment partnership.

(8) For the purposes of this regulation—

"limited partnership" has the meaning given in the Limited Partnerships Act 1907(**a**);

(**a**) 2011 c. 20.
(**b**) 2004 c. 21; section 5A was inserted by section 9(1) of the Localism Act 2011.
(**c**) Section 22 was amended by section 7(1) of the Financial Services act 2012 (c.21).
(**d**) Paragraph 15 was amended by S.I. 2007/126.

"recognised stock exchange" has the same meaning as in section 1005 of the Income Tax Act 2007(**b**);

"traded option" means an option quoted on a recognised stock exchange; and

"unquoted securities investment partnership" means a partnership for investing in securities which are not quoted on a recognised stock exchange when the partnership buys them.

Management of a pension fund

4.—(1) An authority must credit to its pension fund(**c**), in addition to any sum otherwise required to be credited by virtue of the 2013 Regulations or the Transitional Regulations—

(a) the amounts payable by it or payable to it under regulations 15(3), 67 and 68 of the 2013 Regulations (employer's contributions and further payments);

(b) all amounts received under regulation 69(1)(a) of the 2013 Regulations (member contributions);

(c) all income arising from investment of the fund; and

(d) all capital money deriving from such investment.

(2) In the case of an authority which maintains more than one pension fund, as respects sums which relate to specific members, the reference in paragraph (1) to the authority's pension fund is to the fund which is the appropriate fund(**d**) for the member in question in accordance with the 2013 Regulations.

(3) Interest under regulation 71 of the 2013 Regulations (interest on late payments by Scheme employers) must be credited to the pension fund to which the overdue payment is due.

(4) An authority must pay any benefits to which any person is entitled by virtue of the 2013 Regulations or the Transitional Regulations from its pension fund.

(5) Any costs, charges and expenses incurred administering a pension fund may be paid from it except for charges prescribed by regulations made under sections 23, 24 or 41 of the Welfare Reform and Pensions Act 1999(**e**) (charges in relation to pension sharing costs)(**f**).

Restriction on power to borrow

5.—(1) Except as provided in this regulation, an authority must not borrow money where the borrowing is liable to be repaid out of its pension fund.

(2) Subject to paragraph (3), an authority may borrow by way of temporary loan or overdraft which is liable to be repaid out of its pension fund, any sums which it may require for the purpose of—

(a) paying benefits due under the Scheme; or

(b) to meet investment commitments arising from the implementation of a decision by it to change the balance between different types of investment.

(3) An authority may only borrow money under paragraph (2) if, at the time of the borrowing, the authority reasonably believes that the sum borrowed and interest charged in respect of that sum can be repaid out of its pension fund within 90 days of the borrowing.

(**a**) 1907 c. 24.

(**b**) 2007 c.3; section 1005 was substituted by the Finance Act 2007 (c. 11) and amended by the Taxation (International and Other Provisions) Act 2010 (c.8).

(**c**) An administering authority is required to maintain a pension fund by regulation 53(1) of, and paragraph 1 of Schedule 3 to the 2013 Regulations.

(**d**) See regulation 53(2) of and Part 2 of Schedule 3 to the 2013 Regulations for provisions relating to an administering authority becoming the "appropriate administering authority" in relation to a person.

(**e**) 1999 c. 30.

(**f**) See S.I. 2000/1047 and S.I. 2000/1049.

Separate bank account

6.—(1) An authority must hold in a separate account kept by it with a deposit-taker all fund money.

(2) "Deposit-taker" for the purposes of paragraph (1) means—

(a) a person who has permission under Part 4A(**a**) of the 2000 Act (permission to carry on regulated activities) to carry on the activities specified by article 5 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (accepting deposits)(**b**);

(b) an EEA firm of the kind mentioned in paragraph 5(b)(**c**) of Schedule 3 to the 2000 Act (EEA passport rights) which has permission under paragraph 15 of that Schedule(**d**) to accept deposits;

(c) the Bank of England or the central bank of an EEA state other than the United Kingdom; or

(d) the National Savings Bank.

(3) An authority must secure that the deposit-taker may not exercise a right of set-off in relation to the account referred to in paragraph (1) in respect of any other account held by the authority or any party connected to the authority.

Investment strategy statement

7.—(1) An authority must, after taking proper advice, formulate an investment strategy which must be in accordance with guidance issued by the Secretary of State.

(2) The authority's investment strategy must include—

(a) a requirement to invest fund money in a wide variety of investments;

(b) the authority's assessment of the suitability of particular investments and types of investments;

(c) the authority's approach to risk, including the ways in which risks are to be measured and managed;

(d) the authority's approach to pooling investments, including the use of collective investment vehicles and shared services;

(e) the authority's policy on how social, environmental or corporate governance considerations are taken into account in the selection, non-selection, retention and realisation of investments; and

(f) the authority's policy on the exercise of the rights (including voting rights) attaching to investments.

(3) The authority's investment strategy must set out the maximum percentage of the total value of all investments of fund money that it will invest in particular investments or classes of investment.

(4) The authority's investment strategy may not permit more than 5% of the total value of all investments of fund money to be invested in entities which are connected with that authority within the meaning of section 212 of the Local Government and Public Involvement in Health Act 2007(**e**).

(5) The authority must consult such persons as it considers appropriate as to the contents of its investment strategy.

(**a**) Part 4A was inserted by section 11 of the Financial Services Act 2012 (c. 21).
(**b**) S.I. 2001/544; article 5 was amended by S.I. 2002/682.
(**c**) Sub-paragraph (b) of paragraph (5) was substituted by S.I. 2006/3211 and then further substituted by S.I. 2013/3115.
(**d**) Paragraph 15 has been amended by S.I. 2003/2066, S.I. 2007/3253, 2012/1906 and 2013/1881.
(**e**) 2007 c. 28; section 212 was amended by the Police Reform and Social Responsibility Act 2011 (c. 13) and there are prospective amendments made by the Local Audit and Accountability Act 2014 (c. 2).

(6) The authority must publish a statement of its investment strategy formulated under paragraph (1) and the first such statement must be published no later than 1st October 2016.

(7) The authority must review and if necessary revise its investment strategy from time to time, and at least every 3 years, and publish a statement of any revisions.

(8) The authority must invest, in accordance with its investment strategy, any fund money that is not needed immediately to make payments from the fund.

Directions by the Secretary of State

8.—(1) This regulation applies in relation to an authority's investment functions under these Regulations and the 2013 Regulations if the Secretary of State is satisfied that the authority is failing to have regard to guidance issued under regulation 7(1) (investment strategy statement).

(2) Where this regulation applies in relation to an authority the Secretary of State may issue a direction requiring all or any of the following—

(a) that the authority make such changes to its investment strategy under regulation 7 as the Secretary of State considers appropriate, within a period of time specified in the direction;

(b) that the authority invest such assets or descriptions of assets as are specified in the direction in such manner as is specified in the direction;

(c) that the investment functions of the authority under these Regulations and under the 2013 Regulations be exercised by the Secretary of State or a person nominated by the Secretary of State for a period specified in the direction or for so long as the Secretary of State considers appropriate;

(d) that the authority comply with any instructions of the Secretary of State or the Secretary of State's nominee in relation to the exercise of its investment functions under these Regulations and the 2013 Regulations and provide such assistance as the Secretary of State or the Secretary of State's nominee may require for the purpose of exercising those functions.

(3) Before making a decision whether to issue a direction under this regulation, and as to the contents of any direction, the Secretary of State must consult the authority concerned.

(4) In reaching a decision whether to issue a direction under this regulation, and as to the contents of any direction, the Secretary of State must have regard to such evidence of the manner in which the authority is discharging or proposes to discharge its investment functions as is reasonably available including—

(a) any report from an actuary appointed under section 13(4) of the Public Service Pensions Act 2013 (employer contributions in funded schemes) or by the authority under section 62 of the 2013 Regulations (actuarial valuations of pension funds);

(b) any report from the local pension board appointed by the authority or from the Local Government Pension Scheme Advisory Board([a]);

(c) any representations made by the authority in response to the consultation under paragraph (3);

(d) any other evidence available that the Secretary of State regards as relevant to whether the authority has been complying with these regulations or acting in accordance with guidance issued under regulation 7(1) (investment strategy statement).

(5) If the Secretary of State is of the opinion that additional information is required to enable a decision to be taken whether to issue a direction under this regulation, or as to what any direction should contain, the Secretary of State may carry out such inquiries as the Secretary of State considers appropriate to obtain that information.

(6) An authority must co-operate with any request from the Secretary of State intended to facilitate the obtaining of information under paragraph (5).

(**a**) The Local Government Pension Scheme Advisory Board is established under regulation 110 of the 2013 Regulations (which was inserted by S.I. 2015/57).

Investment managers

9.—(1) Instead of managing and investing fund money itself, an authority may appoint one or more investment managers to manage and invest fund money, or any part of such money, on its behalf.

(2) The authority must reasonably believe that the investment manager's ability in and practical experience of financial matters make that investment manager suitably qualified to make investment decisions for it.

(3) The authority must take proper advice in relation to the appointment and the terms on which the appointment is made.

Investments under section 11(1) of the Trustee Investments Act 1961

10. An authority to which section 11 of the Trustee Investments Act 1961(**a**) applies may invest, without any restriction as to quantity, in any investment made in accordance with a scheme under section 11(1) of that Act (which enables the Treasury to approve schemes for local authorities to invest in collectively).

Consequential amendments

11.—(1) The 2013 Regulations are amended as follows.

(2) For regulation 57(1)(a) (pension fund annual report) substitute—

> "(i) the current version of the investment strategy under regulation 7 (investment strategy statement) of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016;".

(3) For regulation 58(4)(b) (funding strategy statement) substitute—

> "(b) the statement of the administering authority's investment strategy published under regulation 7 (investment strategy statement) of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016.".

(4) For regulation 69(2)(b) (payment by Scheme employers to administering authorities) substitute—

> "(b) paragraph (1)(c) does not apply where the cost of the administration of the fund is paid out of the fund under regulation 4(5) (management of a pension fund) of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016.".

Revocations and transitional provision

12.—(1) Subject to paragraph (2), the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009(**b**) and the Local Government Pension Scheme (Management and Investment of Funds) (Amendment) Regulations 2013(**c**) are revoked.

(2) Regulations 11 (investment policy and investment of pension fund money), 12 (statement of investment principles), 14 (restrictions on investments), 15 (requirements for increased limits) of and Schedule 1 (table of limits on investments) to the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 continue to have effect in relation to an authority until the date when that authority publishes its investment strategy statement under regulation 7(1) (investment strategy statement).

(3) For the period starting on 1st April 2016 and ending on whichever is the earlier of the date the authority publishes its investment strategy statement under regulation 7 (investment strategy

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(**a**) 1961 c. 62; section 11(1) was amended by the London Government Act 1963 (c. 4) and the Local Government Act 1985 (c. 51).
(**b**) S.I. 2009/3093.
(**c**) S.I. 2013/410.

statement), or 30th September 2016, Regulation 7 applies to an authority only to the extent necessary to enable that authority to formulate and publish its investment strategy statement.

We consent to the making of these Regulations

Names
Date — Two of the Lords Commissioners of Her Majesty's Treasury

Signed by authority of the Secretary of State for Communities and Local Government

Name
Parliamentary Under Secretary of State
Date — Department for Communities and Local Government

EXPLANATORY NOTE

(This note is not part of the Regulations)

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Pension Fund Committee

15 December 2015

Local Government Pension Scheme: Investment Reform Criteria and Guidance

Report of Don McLure, Corporate Director Resources

Purpose of the report

1 To provide Members with information on the Local Government Pension Scheme (LGPS): Investment Reform Criteria recently published by the Government, which provides details of how LGPS funds will be expected to pool their investments.

Background

2 In the July 2015 Budget, the Chancellor announced the Government's intention to work with LGPS administering authorities to ensure they pool investments to significantly reduce costs whilst maintaining performance. Considerable emphasis was also given to the expectation that LGPS funds would begin to invest substantially more in infrastructure.

Investment Reform Criteria

3 As part of its Autumn Statement, on 25 November 2015 the Government published its Investment Reform Criteria and Guidance, setting out how LGPS investment pooling will work, and reframing the requirement that the pools should take the form of up to six "British Wealth Funds" each with assets of at least £25 billion which are "able to invest in infrastructure and drive local growth".
.

4 It is left to administering authorities to suggest how pooling arrangements should be constituted and will operate, although authorities will need to have regard to the following four criteria:

(i) **Asset pool(s) that achieve the benefit of scale of at least £25 billion** –

Authorities need to explain the size of the pool when fully operational, any assets proposed to be held outside the pool (with rationale), the type of pool including legal structure, how the pool will operate – what work will be carried out internally and what services hired externally, and a timetable for moving assets into the pool(s);

(ii) **Strong governance and decision making**

A governance structure should give assurance that at a local level an authority's investment portfolio is being appropriately managed by the

pool in line with investment strategy and in the long-term interest of their members;
At pool level, risk is adequately assessed and managed, investment implementation decisions are made with a long-term view and a continuous improvement culture is adopted;
Authorities need to revisit their internal processes to ensure efficient and effective decision making and risk management while keeping appropriate democratic accountability. Authorities should explain:

- Governance structure of pool(s) including interaction with elected councillors and external scrutiny;
- How authorities can hold the pool(s) to account;
- Decision making processes (and their rationale) at all stages of investment;
- Shared objective for the pool(s), and any policies agreed between participants;
- Resources allocated to running the pool(s), number of staff, skills and expertise required;
- How environmental, social and corporate governance policies will be handled by the pool(s);
- How authorities will act as responsible, long term investors through the pool(s);
- How the net performance of each asset class in the pool(s) will be publically reported and how benchmarking will be used to assess pool(s) and authority performance.

(iii) Reduced costs and excellent value for money

Authorities are encouraged to report more transparently on investment fees and transaction charges, as it is recognised that some transaction charges are sometimes hidden and often not fully reported in pension fund accounts.
Active management should only be used “where it can be shown to deliver value for money”, and authorities should report how active management, net of fees, compares with a passive index. Authorities are also encouraged to set targets for active managers over “an appropriate long term time period”.
The proposals should include:

- A fully transparent assessment of investment costs and fees as at 31 March 2013 and as at a current date;
- A detailed estimate of savings over the next 15 years and of implementation and transition costs and how they will be met.

(iv) An improved capacity to invest in infrastructure

Proposals should explain how infrastructure will feature in authorities’ investment strategies and how the pooling arrangements can improve the capacity and capability to invest in infrastructure. Authorities should explain:

- The proportion of their funds currently invested in infrastructure;
- How they might develop or acquire capacity and capability to assess infrastructure projects, and reduce costs through managing investments direct though the pool(s);

- The proportion of their fund they intend to invest in infrastructure and how they arrived at that amount.

Addressing the criteria – requirements and timetable

5 Administering authorities need to submit initial proposals to the Government by 19 February 2016. The submission should include a commitment to pooling and a description of progress towards formalising their arrangements with other authorities. The submission can be individual, or joint, or both at this stage.

6 Completed submissions are required by 15 July 2016 that fully meet the criteria set out above and in the consultation document. At this second stage submissions should comprise:

- A joint proposal for each pool setting out the detail of the pooling arrangement e.g. the governance structures, decision-making processes and implementation timetable and;
- For each authority, an individual return setting out the authority's commitment to and expectations of the pool(s), including their profile of costs / savings, the transition profile for their assets and the rationale for any assets they propose holding outside the pool(s) in the long term.

7 The Government will continue to engage with authorities as proposals are developed and will evaluate the initial submissions against the criteria and provide feedback.

8 Final submissions will be assessed and a brief report provided in response. The Government will work with authorities who do not develop "sufficiently ambitious" proposals to help them deliver a more cost effective outcome. If this is not possible, other options will be considered including the use of 'back stop' legislative powers included in the proposed new LGPS investment regulations.

9 Transition to new pools is expected to start within a further 18 months, with liquid assets being transferred from April 2018. It is acknowledged that illiquid assets could take considerably longer to transfer. While pools are being established, authorities should continue to manage their own investment strategies and manager appointments and keep both under regular review.

10 To assist development of proposals, the Government has made available Price Waterhouse Cooper's detailed technical analysis of the different collective investment vehicles and tax arrangements. This suggests an 'Authorised Contractual Scheme' is the most appropriate structure for the LGPS to establish suitable and effective collective investment vehicles to facilitate pooled investment.

Initial pooling discussions

11 Officers from the Council attended a meeting in Leeds and a follow-up conference call in November to discuss early options around a potential investment pool focussing mainly on LGPS Funds in the north of England.

12 The membership of the group is fluid and as yet no commitments have been made. The LGPS Funds involved in the discussion on 25 November 2015 were as set out in the table below:

Fund	Assets at 31.03.15	Fund	Assets at 31.03.15
Greater Manchester	£17.6 bn	London PFA	£4.6 bn
West Yorkshire	£11.3 bn	Teesside	£3.4 bn
Merseyside	£6.9 bn	North Yorkshire	£2.4 bn
South Yorkshire	£6.5 bn	Durham	£2.3 bn
Tyne and Wear	£6.4 bn	Northumberland	£1.1 bn
Lancashire	£5.8 bn	**Total**	**£68.3 bn**

13 One significant feature of the group as constituted at that meeting is that over £20 billion of the group's assets are currently internally managed, including almost all the assets of the West Yorkshire, South Yorkshire and Teesside Pension Funds. If the Durham County Council Pension Fund was able to access internal management through a pooled arrangement, this would be expected to lead to reduced overall investment management costs.

Recommendation

Members are asked to:

14 Agree that the Corporate Director Resources in consultation with the Chairman and Vice Chairman and after taking appropriate advice, provides an initial response to Government on which pool the Durham Pension Fund may be prepared to join.

15 Agree that a progress report will be provided to the next Committee meeting.

Contact: Nick Orton Tel: 03000 269798

Department for Communities and Local Government

Local Government Pension Scheme: Investment Reform Criteria and Guidance

November 2015
Department for Communities and Local Government

This document/publication is also available on our website at www.gov.uk/dclg

If you have any enquiries regarding this document/publication, complete the form at http://forms.communities.gov.uk/ or write to us at:

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Contents

Ministerial Foreword

At the summer Budget 2015, the Chancellor announced our intention to invite administering authorities to bring forward proposals for pooling Local Government Pension Scheme investments, to deliver significantly reduced costs while maintaining overall investment performance.

We have been clear for some time that the existing arrangements for investment by the Local Government Pension Scheme are in need of reform, and the announcement made plain our expectation that authorities would be ambitious when developing their proposals. The publication of these criteria and their supporting guidance marks a significant milestone on the road to reform, placing authorities in a strong position to take the initiative and drive efficiencies in the Scheme, and ultimately deliver savings for local taxpayers.

The Scheme is currently organised through 89 separate local government administering authorities and a closed Environment Agency scheme, which each manage and invest their assets largely independently. Recognising the potential for greater efficiency in this system, the coalition government first began to consider the opportunity for collaboration in 2013 with a call for evidence. Since then, we have been exploring the opportunities to improve; gathering evidence, testing proposals, and listening to the views of administering authorities and the fund management industry.

The Chancellor's announcement draws on this earlier work and in particular the consultation, *Opportunities for collaboration, cost savings and efficiencies,* published in May 2014 by the coalition government. More than 200 consultation responses and papers were received and analysed, leading to the development of a framework for reform that has administering authorities at its centre. The criteria published today make clear the Government's expectation for ambitious proposals for pooling, and invite authorities to lead the design and implementation of their own pools. The criteria have been shaped and informed by earlier consultations, as well as several conversations with administering authorities and the fund management industry which took place over the summer.

Working together, authorities have a real opportunity to realise the benefits of scale that should be available to one of Europe's largest funded pension schemes. The creation of up to six British Wealth Funds, each with at least £25bn of Scheme assets, will not only drive down investment costs but also enable the authorities to develop the capacity and capability to become a world leader in infrastructure investment and help drive growth. I know that many authorities have already started to consider who they will work with and how best to achieve the benefits of scale. These early discussions place those authorities on a strong footing to deliver against our criteria, and I look forward to seeing their proposals develop over the coming months.

Marcus Jones

Criteria

1.1 In the July Budget 2015, the Chancellor announced the Government's intention to work with Local Government Pension Scheme (the Scheme) administering authorities to ensure that they pool investments to significantly reduce costs while maintaining overall investment performance. Authorities are now invited to submit proposals for pooling which the Government will assess against the criteria in this document. The Chancellor has announced that the pools should take the form of up to six British Wealth Funds, each with assets of at least £25bn, which are able to invest in infrastructure and drive local growth.

1.2 The following criteria set out how administering authorities can deliver against the Government's expectations of pooling assets.

1.3 It will be for authorities to suggest how their pooling arrangements will be constituted and will operate. In developing proposals, they should have regard to each of the four criteria, which are designed to be read in conjunction with the supporting guidance that follows. Their submissions should describe:

A. **Asset pool(s) that achieve the benefits of scale:** The 90 administering authorities in England and Wales should collaborate to establish, and invest through asset pools, each with at least £25bn of Scheme assets. The proposals should describe these pools, explain how each administering authority's assets will be allocated among the pools, describe the scale benefits that these arrangements are expected to deliver and explain how those benefits will be realised, measured and reported. Authorities should explain:

   - The size of their pool(s) once fully operational.
   - In keeping with the supporting guidance, any assets they propose to hold outside the pool(s), and the rationale for doing so.
   - The type of pool(s) they are participating in, including the legal structure if relevant.
   - How the pool(s) will operate, the work to be carried out internally and services to be hired from outside.
   - The timetable for establishing the pool(s) and moving their assets into the pool(s). Authorities should explain how they will transparently report progress against that timetable.

B. **Strong governance and decision making:** The proposed governance structure for the pools should:

   i. At the local level, provide authorities with assurance that their investments are being managed appropriately by the pool, in line with their stated investment strategy and in the long-term interests of their members;

   ii. At the pool level, ensure that risk is adequately assessed and managed, investment implementation decisions are made with a long-term view, and a culture of continuous improvement is adopted.

Authorities should also revisit their internal processes to ensure efficient and effective decision making and risk management, while maintaining appropriate democratic accountability. Authorities should explain:

- The governance structure for their pool(s), including the accountability between the pool(s) and elected councillors, and how external scrutiny will be used.
- The mechanisms by which the authority can hold the pool(s) to account and secure assurance that their investment strategy is being implemented effectively and their investments are being well managed.
- Decision making procedures at all stages of investment, and the rationale underpinning this.
- The shared objectives for the pool(s), and any policies that are to be agreed between participants.
- The resources allocated to the running of the pool(s), including the governance budget, the number of staff needed and the skills and expertise required.
- How any environmental, social and corporate governance policies will be handled by the pool(s).
- How the authorities will act as responsible, long term investors through the pool(s), including how the pool(s) will determine and enact stewardship responsibilities.
- How the net performance of each asset class will be reported publically by the pool, to encourage the sharing of data and best practice.
- The extent to which benchmarking is used by the authority to assess their own governance and performance and that of the pool(s), for example by undertaking the Scheme Advisory Board's key performance indicator assessment.

C. **Reduced costs and excellent value for money:** In addition to the fees paid for investment, there are further hidden costs that are difficult to ascertain and so are rarely reported in most pension fund accounts. To identify savings, authorities are expected to take the lead in this area and report the costs they incur more transparently. Proposals should explain how the pool(s) will deliver substantial savings in investment fees, both in the near term and over the next 15 years, while at least maintaining overall investment performance.

Active fund management should only be used where it can be shown to deliver value for money, and authorities should report how fees and net performance in each listed asset class compare to a passive index. In addition authorities should consider setting targets for active managers which are focused on achieving risk-adjusted returns over an appropriate long term time period, rather than solely focusing on short term performance comparisons.

As part of their proposals, authorities should provide:

- A fully transparent assessment of investment costs and fees as at 31 March 2013.
- A fully transparent assessment of current investment costs and fees, prepared on the same basis as 2013 for comparison.
- A detailed estimate of savings over the next 15 years.

- A detailed estimate of implementation costs and when they will arise, including transition costs as assets are migrated into the pool(s), and an explanation of how these costs will be met.
- A proposal for reporting transparently against their forecast transition costs and savings, as well as how they will report fees and net performance.

D. **An improved capacity to invest in infrastructure:** Only a very small proportion of Local Government Pension Scheme assets are currently invested in infrastructure; pooling of assets may facilitate greater investment in this area. Proposals should explain how infrastructure will feature in authorities' investment strategies and how the pooling arrangements can improve the capacity and capability to invest in this asset class. Authorities should explain:

- The proportion of their fund currently allocated to infrastructure, both directly and through funds, or "fund of funds".
- How they might develop or acquire the capacity and capability to assess infrastructure projects, and reduce costs by managing any subsequent investments directly through the pool(s), rather than existing fund, or "fund of funds" arrangements.
- The proportion of their fund they intend to invest in infrastructure, and their ambition in this area going forward, as well as how they have arrived at that amount.

Addressing the criteria

Requirements and Timetable

2.1 Authorities are asked to submit their initial proposals to the Government to LGPSReform@communities.gsi.gov.uk by 19 February 2016. Submissions should include a commitment to pooling and a description of their progress towards formalising their arrangements with other authorities. Authorities can choose whether to make individual or joint submissions, or both, at this first stage.

2.2 Refined and completed submissions are expected by 15 July 2016, which fully address the criteria in this document, and provide any further information that would be helpful in evaluating the proposals. At this second stage, the submissions should comprise:

- for each pool, a joint proposal from participating authorities setting out the pooling arrangement in detail. For example, this may cover the governance structures, decision-making processes and implementation timetable; and
- for each authority, an individual return detailing the authority's commitment to, and expectations of, the pool(s). This should include their profile of costs and savings, the transition profile for their assets, and the rationale for any assets they intend to hold outside of the pools in the long term.

Assessing the proposals against criteria

2.3 The Government will continue to engage with authorities as they develop their proposals for pooling assets over the coming months. The initial submissions will be evaluated against the criteria, with feedback provided to highlight areas that may fall outside of the criteria, or where additional evidence may be required.

2.4 Once submitted, the Government will assess the final proposals against the criteria. A brief report will be provided in response, setting out the extent to which the criteria have been met and highlighting any aspects of the guidance that the Government believes have not been adequately addressed. In the first instance, the Government will work with authorities who do not develop sufficiently ambitious proposals to help them deliver a more cost effective approach to investment that draws on the benefits of scale. Where this is not possible, the Government will consider how else it can drive value for money for taxpayers, including through the use of the "backstop" legislation, should this be in place following the outcome of the consultation described below.

Transitional arrangements

2.5 Plans should be made to transfer assets to the pools as soon as practicable. Analysis commissioned by the Government from PricewaterhouseCoopers (PwC) indicates that, even those pooling mechanisms requiring supporting infrastructure, such as collective investment vehicles, could be established within 18 months. It is expected that liquid assets are transferred into the pools over a relatively short timeframe, beginning from April 2018. It is recognised that illiquid assets are likely to transition over a longer period of time. For the avoidance of doubt, investments with high penalty costs for early exit should not be wound up early on account of the pooling arrangements, but should be transferred across as soon as practicable, taking into account value for money considerations. Any assets that are held outside of the pool should be kept under review to ensure that arrangement continues to provide value for money.

2.6 While authorities will need to be mindful of their developing pooled approach, they should continue to manage both their investment strategies and manager appointments as they do now until the new arrangements are in place. In keeping with the investment regulations, they are still responsible for keeping both under regular review.

Support to develop proposals

2.7 To help authorities develop proposals quickly and efficiently, the Government has made available PwC's detailed technical analysis of the different collective investment vehicles and their tax arrangements at: https://www.gov.uk/government/publications/local-government-pension-scheme-investment-reform-criteria-and-guidance. This paper is provided for information only. It does not represent the view of Government, and authorities should seek professional advice as needed when developing their proposals. Authorities are also strongly encouraged to learn from those who have already begun to develop collective investment vehicles, such as the London Boroughs or Lancashire and the London Pension Fund Authority.

Legislative context

2.8 At the July Budget 2015, the Chancellor also announced the Government's intention to consult on "backstop" legislation that would require those administering authorities who do not come forward with sufficiently ambitious proposals to pool their assets with others. That consultation has now been published and is available on the Government's website at: https://www.gov.uk/government/consultations/revoking-and-replacing-the-local-government-pension-scheme.

2.9 The consultation proposes to introduce a power for the Secretary of State to intervene in the investment function of an administering authority where it has not had sufficient regard to guidance published by the Secretary of State. The intervention should be proportionate and subject to both consultation and review.

2.10 The draft regulations include a provision for the Secretary of State to issue guidance. Subject to the outcome of the consultation, authorities would then need to have regard to that guidance when producing their investment strategy. The Government proposes to issue this document as Secretary of State's guidance if the draft regulations come into effect. The guidance will be kept under review and may be updated, for example if the proposals for pooling that come forward are not sufficiently ambitious.

2.11 The consultation also proposes to replace and update the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 to make significant investment through pooled vehicles possible.

Supporting guidance

3.1 This guidance is to assist authorities in the design of ambitious proposals for pooling investments and to provide ongoing support as they seek to ensure value for money in the long term. It will be kept under review to ensure that it continues to represent best practice.

A. Asset pool(s) that achieve the benefits of scale

Headline criterion: The 90 administering authorities in England and Wales should collaborate to establish, and invest through asset pools, each with at least £25bn of Scheme assets. The proposals should describe these pools, explain how each administering authority's assets will be allocated among the pools, describe the scale benefits that these arrangements are expected to deliver and explain how those benefits will be realised, measured and reported.

3.2 The consultation, *Opportunities for collaboration, cost savings and efficiencies*, set out strong evidence that demonstrated how using collective investment vehicles and pooling investments can deliver substantial savings for the Local Government Pension Scheme without affecting investment performance. Additional advantages to pooling, which should further reduce costs and improve decision making in the long term, include:

- Increasing the range of asset classes to be invested in directly,
- Strengthening the governance arrangements and in-house expertise available to authorities,
- Improving transparency and long-term stewardship, and
- Facilitating better dissemination of best practice and performance data between authorities.

The case for collective investment

3.3 Published in May 2014, the analysis in the Hymans Robertson report evidenced that using collective investment vehicles could deliver savings. In the case of illiquid assets alone, they found that £240m a year could be saved if investments were channelled through a Scheme wide collective investment vehicle rather than the existing "fund of funds" approach.[1]

3.4 A review of the academic analysis available also supports the case for larger investment pools. For example, Dyck and Pomorski's paper, *Is Bigger Better? Size and performance in pension fund management*, established that larger pension funds were able to operate at lower cost than their smaller counterparts, through a combination of

[1] Hymans Robertson report: *Local Government Pension Scheme structure analysis,* p.3 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/307926/Hymans_Robertson_report.pdf

improved negotiating power, greater use of in-house management, and more cost effective access to alternative assets like infrastructure.[2]

> A third to a half of the benefits of size come through cost savings realized by larger plans, primarily via internal management. Up to two thirds of the economies come from substantial gains in both gross and net returns on alternatives.

3.5 A number of respondents to the May 2014 consultation also set out the case for larger funds being able to access lower cost investments. London Councils, for example, estimated that savings of £120m a year could be delivered if £24bn was invested through the London collective investment vehicle (CIV), as a result of reduced investment management fees, improved performance, and enhanced efficiency.

3.6 Formal mechanisms of pooling, such as collective investment vehicles, offer additional benefits to alternative arrangements such as procurement frameworks. For example, Hymans Robertson explained that larger asset pools would increase the opportunities for buy and sell transactions to be carried out within the Scheme, reducing the need to go to the market and so minimising transaction costs. Their analysis found that this could reduce transaction costs, which erode the value of assets invested, by £190m a year.[3]

3.7 Pooling investments will also create an opportunity to improve transparency and information sharing amongst authorities. By having a single entity responsible for negotiating with fund managers and reporting performance, authorities can see what they are paying and generating in returns and how it compares with other authorities. Similarly, Lancashire County Pension Fund and the London Pension Fund Authority, who are developing a pool for assets and liabilities, anticipate economies of scale driving improved performance. They have recently estimated that by pooling they can achieve enhanced investment outcomes of £20-£30m a year from their current levels.[4]

Achieving appropriate scale

3.8 The Government expects all administering authorities to pool their investments to achieve economies of scale and the wider benefits of sharing best practice.

3.9 A move to larger asset pools would also be in keeping with international experience. For example, in Ontario, smaller public sector pension funds are being required to come together to form pools of around $50bn Canadian (approximately £30bn at the time the proposal was made). Similarly, Australian pension funds have been consolidating in recent years, where a formal review in 2010 recommended that each MySuper pension fund be required to consider annually whether they have sufficient scale and membership to continue as a separate pension fund.[5]

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[2] Dyck and Pomorski, *Is bigger better? Size and Performance in Pension Plan Management*, pp.14-15
[3] Hymans Robertson report, pp.14-15
[4] Sir Merrick Cockell, writing in the *Pensions Expert* on 30 September 2015
[5] Government Response to the Review into the Governance, Efficiency, Structure and Operation of Australia's Superannuation System, Recommendation 1.6,

3.10 The May 2014 consultation sought views on the number of collective investment vehicles to be established. Respondents stressed the importance of balancing the need for scale with local input and practical governance arrangements. It was also argued that while larger asset pools would deliver greater savings, the potential difficulties of successfully investing large volumes of assets in a single asset class, particularly active strategies for listed assets, should also be taken into account. However, while individual managers may restrict the value of assets they are prepared to accept or are able to invest, the selection of a few managers for each asset class would help to mitigate this risk.

3.11 Having reflected on the views expressed in response to the consultation and the experience of pension funds internationally, the Government believes that in almost all cases, fewer, larger assets pools will create the conditions for lower costs and reduce the likelihood of activity being duplicated across the Scheme, for example by minimising pooled vehicle set-up and running costs. It therefore expects authorities to collaborate and invest through no more than six large asset pools, each with at least £25bn of Local Government Pension Scheme assets under management once fully operational.

3.12 However, the Government recognises that there may be a limited number of bespoke circumstances where an alternative arrangement may be more appropriate for a particular asset class or specific investment. As set out below, this may include pooling to invest in illiquid assets like infrastructure, direct holdings in property and locally targeted investments.

Investment in infrastructure and other illiquid or alternative assets

3.13 The Hymans Robertson report highlighted illiquid or alternative assets as an area for significant savings for the Scheme. They found that in 2012-2013, illiquid asset classes like private equity, hedge funds and infrastructure represented just 10% of investments made, but 40% of investment fees. They also demonstrated that changing the way these investments are made, moving away from “fund of funds” to a collective investment vehicle, could save £240m a year.[6]

3.14 The Government expects the pooling of assets to remove some of the obstacles to investing in these asset classes in a cost effective way. A separate criterion has been included on infrastructure, although similar benefits exist for other alternative or illiquid assets, such as private equity, venture capital, debt funds and new forms of alternative business finance. In light of this, authorities should consider how best to access these asset classes in a more cost-effective way. Regionally based pools, such as the London boroughs’ collective investment vehicle, would allow authorities to make best use of existing relationships, while a single national pool for infrastructure or illiquid assets would deliver even greater scale and opportunity for efficiency.

3.15 A considerable shift in asset allocation would be needed to develop a pool of £25bn for investment in infrastructure and other illiquid or alternative assets, such as private equity or venture capital. The Government recognises that such a significant movement in

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http://strongersuper.treasury.gov.au/content/Content.aspx?doc=publications/government_response/recommendation_response_chapter_1.htm

[6] Hymans Robertson report, p.24

asset allocation is unlikely in the near term. As such, should authorities elect to develop a single asset pool for illiquid investments or infrastructure, the Government recognises that a value of assets under management less than £25bn might be appropriate.

Investments outside of the pools

3.16 The Government's presumption is that all investments should be made through the pool, but we recognise that there may be a limited number of existing investments that might be less suitable to pooled arrangements, such as local initiatives or products tailored to specific liabilities. Authorities may therefore wish to explore whether to retain a small proportion of their existing investments outside of the pool, where this can demonstrate clear value for money. Any exemptions should be minimal and must be set out in the pooling proposal, alongside a supporting rationale.

Property

3.17 As of the 31 March 2014, authorities reported that they were investing around 2.5% of their assets in directly held property, with a further 4.1% invested through property investment vehicles.[7] However, the amount invested varies considerably between authorities, with some targeting investment of around 10% of their assets in direct holdings, for example.

3.18 A number of consultation responses stressed the importance of retaining direct ownership of property outside of any pooled arrangement, a view echoed in our discussions with interested parties over the summer. Directly held property is used by some authorities to match a particular part of an authority's liabilities, or to generate regular income. If these assets were then pooled, while the authority would receive the benefits of the pooled properties, there is a risk that this would not match the liability or cash-flow requirements that had underpinned the decision to invest in a particular property.

3.19 In light of the arguments brought forward by authorities and the fund management industry, the Government is prepared to accept that some existing property assets might be more effectively managed directly and not through a pool at present. However, pools should be used if new allocations are made to property, taking advantage of the opportunity to share the costs associated with the identification and management of suitable investments.

3.20 Where authorities invest more than the reported Scheme average of 2.5% in property directly, they should make this clear in their pooling submission.

Addressing the criterion

3.21 When developing their proposals for pooling, authorities should set out:

- The size of their pool(s) once fully operational.
- In keeping with the supporting guidance, any assets they propose to hold outside the pool(s), and the rationale for doing so.

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[7] Scheme Advisory Board, Annual Report http://www.lgpsboard.org/index.php/investment-performance-2014

- The type of pool(s) they are participating in, including the legal structure if relevant.
- How the pool(s) will operate, the work to be carried out internally and services to be hired from outside.
- The timetable for establishing the pool(s) and moving their assets into the pool(s). Authorities should explain how they will transparently report progress against that timetable.

B. Strong governance and decision making

Headline criterion: The proposed governance structure for the pools should:

i. At the local level, provide authorities with assurance that their investments are being managed appropriately by the pool, in line with their stated investment strategy and in the long-term interests of their members;

ii. At the pool level, ensure that risk is adequately assessed and managed, investment implementation decisions are made with a long-term view, and a culture of continuous improvement is adopted.

Authorities should also revisit their internal processes to ensure efficient and effective decision making and risk management, while maintaining appropriate democratic accountability.

3.22 A number of consultation responses stressed the importance of establishing strong governance arrangements for pools. Securing the right balance between local input and timely, effective decision making was viewed as essential, but also a significant challenge. The management and governance arrangements of each pool will inevitably be defined by the needs of those participating. However, there are some underlying principles that the Government believes should be incorporated.

Maintaining democratic accountability

3.23 The May 2014 consultation was underpinned by the principle that asset allocation should remain with the administering authorities. Consultation respondents were strongly in favour of retaining local asset allocation, noting that each fund has a unique set of participating employers, liabilities, membership and cash-flow profiles, which need to be addressed by an investment strategy tailored to those particular circumstances.

3.24 Respondents also highlighted the transparency and accountability benefits offered by local asset allocation. If councillors are responsible for setting the investment strategy, then local taxpayers, who in part fund the Scheme through employer contributions, have an opportunity to hold their decisions directly to account through local elections. As one consultation response explained:

> The accountability of Members of the employing authorities playing a part in deciding locally how the assets of the Pension Fund are allocated is important. Employer contributions are paid, in the main, by local council tax payers who in turn vote for their local councillors. Those councillors should have the autonomy to make decisions relating to the investment strategy of that Pension Fund.

3.25 The Government agrees that this democratic link is important to the effective running of the Scheme and should not be wholly removed by the pooling of investments. As set out below, determining the investment strategy and setting the strategic asset allocation should remain with individual authorities. When developing a pool, authorities should ensure that there remains a clear link through the governance structure adopted, between the pool and the pensions committee. For example, this might take the form of a shareholding in the pool for the authority, which is exercised by a member of the pension committee.

Strategic asset allocation

3.26 Establishing the right investment strategy and strategic asset allocation is crucial to optimising performance. It is increasingly accepted that strategic asset allocation is one of the main drivers of investment returns, having far greater an impact than implementation decisions such as manager selection.

3.27 The majority of respondents to the May 2014 consultation supported local asset allocation, but discussions with interested parties over the summer have highlighted a lack of consensus as to what constitutes strategic asset allocation. Definitions have ranged from selecting high level asset classes such as the proportions in bonds, equities and property; to developing a detailed strategy setting out the extent and types of investments in each of the different equity or bond markets.

3.28 Informed by these discussions with fund managers and administering authorities, the Government believes that pension committees should continue to set the balance between investment in bonds and equities, recognising their authority's specific liability and cash-flow forecasts. Beyond this, it will be for each pool to determine which aspects of asset allocation are undertaken by the pool and which by the administering authority, having considered how best to structure decision making in order to deliver value for money. Authorities will need to consider the additional benefits of centralising decision making to better exploit synergies with other participating authorities' allocations and further drive economies of scale. When setting out their asset allocation authorities should be as transparent as possible, for example making clear the underlying asset class sought when using pooled funds.

Effective and timely decision making

3.29 Authorities should draw a distinction between locally setting the strategic asset allocation and centrally determining how that strategy is implemented. The Government expects that implementation of the investment strategy will be delegated to officers or the pool, in order to make the most of the benefits of scale and react efficiently to changing market conditions. As one consultation response suggested:

> We believe that high-level decisions about Fund objectives, strategy and allocation are best made by individual Funds considering their better knowledge of their liabilities, risk and return objectives and cash flow requirements. More detailed asset allocation decisions should however be centralised to achieve better economies of scale, and to allow more specialist management.

3.30 Authorities will need to revisit and review their decision-making processes as part of their move towards pools. For example, in order to maximise savings, manager selection will need to be undertaken at the pool level. Centralising manager selection would allow the pool to rationalise the number of managers used for a particular asset class. The resulting larger mandates should then allow the pool to negotiate lower investment fees. This approach would also give local councillors more time to dedicate to the fundamental issue of setting the overarching strategy.

3.31 A number of authorities have already delegated hiring and dismissing mangers to a sub-committee comprised predominantly of officers. This has allowed these authorities to react more quickly to changes in the market, taking advantage of opportunities as they arise. Similarly, delegating implementation decisions to the pool will allow the participating authorities to benefit not only from more streamlined decision making, but also from effecting those decisions at scale.

3.32 The creation of pools will necessarily lead to a review of decision making within each authority. The Government expects to see greater consolidation where possible. However, as a minimum, we would expect to see the selection of external fund managers and the implementation of the investment strategy to be carried out at the pooled level.

Responsible investment and effective stewardship

3.33 In June 2011, the Government invited Professor John Kay to conduct a review into UK equity markets and long-term decision making. The Kay Review considered how well equity markets were achieving their core purposes: to enhance the performance of UK companies and to enable savers to benefit from the activity of these businesses through returns to direct and indirect ownership of shares in UK companies. The review identified that short-termism is a problem in UK equity markets.[8]

3.34 Professor Kay recommended that Company directors, asset managers and asset holders adopt measures to promote both stewardship and long-term decision making. In particular, he stressed that 'asset managers can contribute more to the performance of British business (and in consequence to overall returns to their savers) through greater involvement with the companies in which they invest.'[9] He concludes that adopting such responsible investment practices will prove beneficial for investors and markets alike.

3.35 In practice, responsible investment could involve making investment decisions based on the long term, as well as playing an active role in corporate governance by exercising shareholder voting rights. Administering authorities will want to consider the findings of the Kay Review when developing their proposals, including what governance procedures and mechanisms would be needed to facilitate long term responsible investing and stewardship through a pool. The UK Stewardship Code, published by the Financial Reporting Council, also provides authorities with guidance on good practice in terms of monitoring, and engaging with, the companies in which they invest.

Enacting an environmental, social and corporate governance policy

3.36 The investment regulations currently require authorities to set out within the statement of investment principles the extent to which social, environmental or corporate governance considerations are taken into account in the selection, retention and realisation of investments. The draft regulations published alongside this document do not propose to amend this principle.

3.37 These policies should be developed in the context of the liability profile of the Scheme, and should enhance the authority's ability to manage down any funding deficit and ensure that pensions can be paid when due. Indeed, environmental, social and

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[8] *The Kay Review of UK Equity Markets and Long-Term Decision Making*, pp. 9-10 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf
[9] The Kay Review, p.12

corporate governance policies provide a useful tool in managing financial risk, as they ensure that the wider risks associated with the viability of an investment are fully recognised.

3.38 As the Law Commission emphasised in its 2014 report on the fiduciary duty of financial intermediaries, the law generally is clear that schemes should consider any factors financially material to the performance of their investments, including social, environmental and corporate governance factors, and over the long-term, dependent on the time horizon over which their liabilities arise.

3.39 The Law Commission also clarified that, although schemes should make the pursuit of a financial return their predominant concern, they may take purely non-financial considerations into account provided that doing so would not involve significant risk of financial detriment to the scheme and where they have good reason to think that scheme members would support their decision.

3.40 The Government's intention is to issue guidance to authorities to clarify that such considerations should not result in policies which pursue municipal boycotts, divestments and sanctions, other than where formal legal sanctions, embargoes and restrictions have been put in place by the Government. Investment policies should not be used to give effect to municipal foreign or munitions policies that run contrary to Government policy.

3.41 Authorities will need to determine how their individual investment policies will be reflected in the pool. They should also consider how pooling could facilitate implementation of their environmental, social and corporate governance policy, for example by sharing best practice, collaborating on social investments to reduce cost or diversify risk, or using their scale to improve capability in this area.

Addressing the criterion

3.42 When developing their proposals for pooling, authorities will need to set out:

- The governance structure for their pool(s), including the accountability between the pool(s) and elected councillors, and how external scrutiny will be used.
- The mechanisms by which the authority can hold the pool(s) to account and secure assurance that their investment strategy is being implemented effectively and their investments are being well managed.
- Decision making procedures at all stages of investment, and the rationale underpinning this.
- The shared objectives for the pool(s), and any policies that are to be agreed between participants.
- The resources allocated to the running of the pool(s), including the governance budget, the number of staff needed and the skills and expertise required.
- How any ethical, social and corporate governance policies will be handled by the pool(s).
- How the authorities will act as responsible, long term investors through the pool(s), including how the pool(s) will determine and enact stewardship responsibilities.

- How the net performance of each asset class will be reported publically by the pool, to encourage the sharing of data and best practice.

- The extent to which benchmarking is used by the authority to assess their own governance and performance and that of the pool(s), for example by undertaking the Scheme Advisory Board's key performance indicator assessment.

C. Reduced costs and excellent value for money

Headline criterion: In addition to the fees paid for investment, there are further hidden costs that are difficult to ascertain and so rarely reported in most pension fund accounts. To identify savings, authorities are expected to take the lead in this area and report the costs they incur more transparently. Proposals should explain how the pool(s) will deliver substantial savings in investment fees, both in the near term and over the next 15 years, while maintaining overall investment performance.

Active fund management should only be used where it can be shown to deliver value for money, and authorities should report how fees and net performance in each listed asset class compare to a passive index. In addition authorities should consider setting targets for active managers which are focused on achieving risk-adjusted returns over an appropriate long term time period, rather than solely focusing on short term performance comparisons.

3.43 As set out in the July Budget 2015 announcement, the Government wants to see authorities bring forward proposals to reform the way their pension scheme investments are made to deliver long-term savings for local taxpayers. Authorities are invited to consider how they might best deliver value for money, minimising fees while maximising overall investment returns.

Scope for savings

3.44 Pooling investments offers an opportunity to share knowledge and reduce external investment management fees, as the fund manager is able to treat the authorities as a single client. There is already a considerable body of evidence in the public domain to support authorities in developing their proposals for investment reform and this continues to grow with new initiatives emerging from local authorities:

- **Passive management:** Hymans Robertson showed that annual fee savings of £230m could be found by moving from active to passive management of listed assets like bonds and equities, without affecting the Scheme's overall return.[10]
- Their analysis suggested that since passive management typically results in fewer shares being traded, turnover costs, which are a drag on the performance achieved through active management, might be reduced by £190m a year.[11]
- **Collective investment:** Hymans Robertson also demonstrated that £240m a year could be saved by using a collective investment vehicle instead of "fund of funds" for illiquid assets like infrastructure, hedge funds and private equity.[12]
- Similarly, the London Pension Fund Authority has estimated that they have reduced their external manager fees by 75% by bringing equity investments in-house, and hope to expand this considerably as part of their collective investment vehicle with Lancashire County Pension Fund.[13]

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[10] Hymans Robertson report, p. 12
[11] Hymans Robertson report, pp. 14-15
[12] Hymans Robertson report, p. 3
[13] Chris Rule, LPFA Chief Investment Officer, reported in *Pension Expert* on 1 October 2015

- **Sharing services and procurement costs:** The National Procurement Framework has also helped authorities to address some of the other costs associated with investment, such as legal and custodian fees, reporting measurable savings of £16m so far.[14]

3.45 As Hymans Robertson's analysis shows, just tackling the use of "fund of funds" for illiquid assets like infrastructure could save around £240m a year, with clear opportunities to go further. It is in this context that the Government is encouraging authorities to bring forward their proposals for collaboration and cost savings. Although a particular savings target has not been set, the Government does expect authorities to be ambitious in their pursuit of economies of scale and value for money.

In-house management

3.46 Some authorities manage all or the majority of their assets internally and so can already show very low management costs. In these cases, a move to a collective investment vehicle with external fund managers is unlikely to deliver cost savings from investment fees alone. However, there are wider benefits of collaboration which authorities with in-house teams should consider when developing their proposals for pooling. A pool of internally managed assets could lead to further reductions in costs, for example by sharing staff, research and due diligence checks; it may improve access to staff with stronger expertise in particular asset classes; and could introduce greater resilience in staff recruitment, retention and succession planning. Alternatively, newly created pools might wish to work with existing in-house teams to build up expertise and take advantage of their lower running costs.

Active and passive management

3.47 The May 2014 consultation considered the use of active and passive management by the Local Government Pension Scheme. Active management attempts to select fund managers who actively choose a portfolio of assets in order to deliver a return against a specific investment target. In practice, this is often used to try and outperform a benchmark, for that class of assets over a specific period. In contrast, passive management tracks a market and aims to deliver a return in line with that market.

3.48 The consultation demonstrated that when considered in aggregate, the Scheme had been achieving a market return over the last ten years in each of the main equity markets. This suggested that collectively the Scheme could have delivered savings by using less costly passive management for listed assets like bonds and equities, without affecting overall performance. While the majority of consultation responses agreed that there was a role for passive management in a balanced portfolio, most also argued that authorities should retain the use of active management where they felt it would deliver higher net returns.

3.49 In response to that consultation, the Government has now invited authorities to bring forward proposals for pooling investments to deliver economies of scale. The extent to which passive management is used will remain a decision for each authority or pool,

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[14] National LGPS Frameworks website, http://www.nationallgpsframeworks.org/national-lgps-frameworks-win-lgc-investment-award

based on their investment strategy, ongoing performance and ability to negotiate lower fees with fund managers. However, in light of the evidence set out in the Hymans Robertson report and the May 2014 consultation, authorities are encouraged to keep their balance of active and passive management under review to ensure they are delivering value for money. For example, should their net returns compare poorly against the index in a particular asset class over the longer term, authorities should consider whether they are still securing value for money for taxpayers and Scheme members.

3.50 When determining how to measure performance, authorities are encouraged to consider setting targets for active managers that are focused on achieving risk-adjusted returns over an appropriate long term time period, rather than solely focusing on short term performance comparisons.

Improving the transparency of costs

3.51 In addition to the fees paid to asset managers, there are considerable hidden costs of investment that are difficult to identify and so often go unreported by investors. In the case of the Local Government Pension Scheme, Hymans Robertson showed that investment costs in 2012-13 were at least £790m a year, in contrast to the £409m reported by the authorities.[15] Even the £790m understated the total investment costs as it excluded performance fees on alternative assets such as private equity and hedge funds (it included performance fees on traditional assets) and turnover costs (investment performance figures include the impact of turnover costs).

3.52 To really drive savings within the Scheme, it is essential that these hidden costs are better understood and reported as transparently as possible. Although many of these costs are not paid out in cash, they do erode the value of the assets available for investment and so should also be scrutinised and the opportunities for savings explored.

3.53 The Chartered Institute of Public Finance and Accountancy (CIPFA) has already made some changes to their guidance, Accounting for Local Government Pension Scheme management costs 2014, to encourage authorities to explore these costs and report some through a note to the accounts. For example, these include performance fees and management fees on pools deducted at source. Authorities should have regard to this guidance and ensure that they are reporting costs as transparently as possible.

3.54 In addition, the Scheme Advisory Board is commissioning advice to help authorities more accurately assess their transparent and hidden investment costs. Once available, authorities should take full advantage of this analysis when developing their proposals.

Addressing the criterion

3.55 As set out above, there is a clear opportunity for authorities to collaborate to deliver hundreds of millions in savings in the medium term. Although there is no overall savings target for the Scheme, the Government expects authorities to take full advantage of the benefits of pooling to reduce costs while maintaining performance.

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[15] Hymans Robertson report, pp.10-11

3.56 To support the delivery of savings authorities bringing forward proposals are asked to set out their current investment costs in detail, and demonstrate how these will be reduced over time and the savings forecast. Where possible, costs should be reported back to 2012-2013 so that any cost reductions already achieved as a result of procurement frameworks and early fee negotiations are transparently captured.

3.57 Authorities are encouraged to provide:

- A fully transparent assessment of investment costs and fees as at 31 March 2013.
- A fully transparent assessment of current investment costs and fees, prepared on the same basis as 2013 for comparison.
- A detailed estimate of savings over the next 15 years.
- A detailed estimate of implementation costs and when they will arise, including transition costs as assets are migrated into the pool(s), and an explanation of how these costs will be met.
- A proposal for reporting transparently against their forecast transition costs and savings, as well as how they will report fees and net performance.

D. An improved capacity and capability to invest in infrastructure

Headline criterion: Only a very small proportion of Local Government Pension Scheme assets are currently invested in infrastructure; pooling of assets may facilitate greater investment in this area. Proposals should explain how infrastructure will feature in authorities' investment strategies and how the pooling arrangements can improve the capacity and capability to invest in this asset class.

3.58 Investment in infrastructure is increasingly being seen as a suitable option for pension funds, particularly amongst larger organisations. This may in part be the result of the typically long term nature of these investments, which may offer a useful match to the long term liabilities held by pension funds.

International experience

3.59 Multiple large international pension funds are investing a significant proportion of their assets in infrastructure. A recent OECD report, which analysed a sample of global pension funds as at 2012, showed that some Canadian and Australian funds (with total assets of approximately £35-40bn in 2014 terms) were investing up to 10-15% in this asset class.[16] The report also noted that those funds with the largest infrastructure allocations were investing directly, and that such investment was the result of the build up of sector-specific knowledge, expertise and resources.[17] This experience might be demonstrated through an organisation's ability to manage large projects, as well as the associated risk.

3.60 Figures published by the Scheme Advisory Board for the 2013 Annual Report show that around £550m, or 0.3%, of the Scheme's total assets of £180bn was invested in infrastructure.[18] This falls some way behind other large pension funds that have elected to invest in this area, such as those noted above and the Ontario Teachers Pension Plan which invested 6.1% according to the same 2014 report.

Creating the opportunity

3.61 The Scheme's current structure, where assets are locked into 90 separate funds, reduces scale and makes significant direct infrastructure investment more difficult for administering authorities. As a result, authorities may determine that they are unable to invest in infrastructure, or may invest indirectly, through the "fund of funds" structure. Such arrangements are expensive, as the Hymans Robertson report demonstrated and this paper sets out in paragraph 3.13.

3.62 Developing larger investment pools of at least £25bn will make it easier to develop or acquire improved capacity and capability to invest in infrastructure. In so doing, it should be possible to reduce the costs associated with investment in this area. This is likely to be the case particularly if authorities pool their infrastructure investment nationally, where the

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[16] OECD, *Annual Survey of Large Pension Funds: report on pension funds' long-term investments*, p.32, available at: http://www.oecd.org/daf/fin/private-pensions/LargestPensionFunds2012Survey.pdf
[17] OECD report, p.14
[18] Scheme Advisory Board annual report http://www.lgpsboard.org/index.php/scheme-investments

resultant scale may allow them to buy-in or build-up in-house expertise in relevant areas, such as project and risk management.

3.63 In considering such investment, administering authorities might want to reflect on the wide range of assets that might be explored, such as railway, road or other transport facilities; utilities services like water and gas infrastructure; health, educational, court or prison facilities, and housing supply. Authorities should also examine the benefits of both:

- Greenfield infrastructure – projects involving the construction of brand new infrastructure, such as a new road or motorway junction to unlock a housing development, or the recent investment of £25m by the Greater Manchester Pension Fund to unlock new sites and build 240 houses; and
- Brownfield infrastructure – investing in pre-existing infrastructure projects, such as taking over the running of (or the construction of a new terminal building at) an airport.

3.64 As set out above, investment in infrastructure represents a viable investment for pension funds, offering long term returns to match their liabilities. Authorities will need to make their investments based on an assessment of risk, return and fit with investment strategy. However, the creation of large pools will make greater investment in infrastructure a more realistic prospect, opening up new opportunities to develop or buy-in the capacity and capability required.

3.65 In developing their proposals for pooling, authorities should take the opportunity to review their asset allocation decisions and consider how they can be more ambitious in their infrastructure investment. The Government believes that authorities can play a leading role in UK infrastructure and driving local growth, and encourages authorities to compare themselves against the example set by the leading global pension fund investors in their approach to allocating assets in this area.

Addressing the criterion

3.66 Authorities should identify their current allocation to infrastructure, and consider how the creation of up to six pools might facilitate greater investment in this area. When developing proposals, authorities should explain:

- The proportion of their fund currently allocated to infrastructure, both directly and through fund, or “fund of funds”.
- How they might develop or acquire the capability and capability to assess infrastructure projects, and reduce costs by managing any subsequent investments directly through the pool(s), rather than existing fund, or “fund of funds” arrangements.
- The proportion of their fund they intend to invest in infrastructure, and their ambition in this area going forward, as well as how they have arrived at that amount.

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Pension Fund Committee

15 December 2015

Audit Completion Report for the year ended 31 March 2015

Don McLure, Corporate Director Resources

Purpose of the Report

1 To inform Members of the completion of the audit of the Pension Fund Accounts and to present the Audit Completion Report for the financial year ended 31 March 2015.

Background

2 A report to the Pension Fund Committee on 10 September 2015 included the Pension Fund Statement of Accounts. At that time, the Accounts were subject to audit by our external Auditor, Mazars LLP.

3 The Statement of Accounts was approved by the Audit Committee on 30 September 2015 and the External Auditor has expressed his opinion on the County Council and Pension Fund Accounts.

4 The Annual Report and Accounts of the Pension Fund, which contains the audited Statement of Accounts, was circulated to Members and was presented to the Annual Meeting of the Pension Fund on 5 November 2015. The Report is available on the County Council's website.

Audit Completion Report

5 The Audit Completion Report and the letter from the External Auditor presented to the Audit Committee on 30 September are attached at Appendix 1 and 2 for Members' information.

6 Appendix B to the Audit Completion Report gives the Auditor's unqualified opinion on the Pension Fund's Financial Statements and the Annual Report:

"In our opinion the Pension Fund's financial statements:

- *give a true and fair view of the financial transactions of the pension fund during the year ended 31 March 2015 and the amount and disposition of the fund's assets and liabilities as at 31 March 2015 other than liabilities to pay pensions and other benefits after the end of the scheme year; and*

- *have been properly prepared in accordance with the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom 2014/15."*

7 Appendix C to the Audit Completion Report gives the Auditor's opinion on the consistency of the Pension Fund's Annual Report and the County Council's Statement of Accounts.

"In our opinion, the pension fund financial statements are consistent with the full statement of accounts of Durham County Council for the year ended 31 March 2015 and comply with applicable law and the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom 2014/15."

8 Section 4 to the Audit Completion Report details the misstatements in the Accounts. There were no adjustments identified during the audit which impacted on the core accounting statements, the Fund Account and the Net Assets Statement.

9 The financial statements have, however, been amended for a number of minor errors, omissions, rounding error corrections, clarifications and typographical errors. The main disclosure note misstatements identified during the course of the audit are outlined in the table in Section 4 to the Audit Completion Report. All of these misstatements have been amended by management:

10 Overall, the External Auditor had no significant issues to report during the audit and had the full co-operation of management.

11 Although, no issues that would impact on the financial accounts were identified, improvements to the Pension Fund financial accounting systems are set out in Section 3 of the Audit Completion Report. Relevant action plans have been established by officers that will be tracked for progress in the coming weeks and months in order to address the identified recommendations and improve the way we manage the financial affairs of the Pension Fund.

Recommendation

12 Members are asked to note the contents of this report.

Background Papers

(a) Pension Fund Committee - 10 September 2015 - Statement of Accounts for the year ended 31 March 2015

(b) Audit Committee - 30 September 2015 - External Audit: Audit Completion Report Year Ended 31 March 2015 – Pension Fund

Contact: Hilary Appleton Tel: 03000 266239

Audit Completion Report

Durham County Council Pension Fund – year ended 31 March 2015

September 2015

Mazars LLP
Rivergreen Centre
Aykley Heads
Durham
DH15 5TS

Audit Committee Members
Durham County Council
County Hall
Durham
DH1 5UE

30 September 2015

Dear Members

Audit Completion Report – Year ended 31 March 2015

We are delighted to present our Audit Completion Report for the year ended 31 March 2015. The purpose of this document is to summarise our audit conclusions.

The scope of our work, including identified significant audit risks and areas of management judgement was outlined in our Audit Strategy Memorandum and Progress Report which we presented in May and July 2015 respectively. We have reviewed our Audit Strategy Memorandum and Progress Report and concluded that the original significant audit risks and areas of management judgement remain appropriate.

We would like to take this opportunity to express our thanks to your officers for their assistance during the course of our audit.

If you would like to discuss any matters in more detail then please do not hesitate to contact me on 0191 383 6300 or cameron.waddell@mazars.co.uk.

Yours faithfully

Cameron Waddell

Director

Mazars LLP

Contents

01 Executive summary

Purpose of this document

This document has been prepared to communicate the findings of our audit for the year ended 31 March 2015 to members of the Audit Committee (Those Charged with Governance) of Durham County Council (the Council) and forms the basis for discussion at the Audit Committee meeting on 30 September 2015.

Our communication with you is important to:

- share information to assist both the auditor and those charged with governance to fulfil our respective responsibilities;
- provide you with constructive observations arising from the audit process;
- ensure, as part of the two-way communication process, we gain an understanding of your attitude and views in respect of the internal and external operational, financial, compliance and other risks facing Durham County Council Pension Fund; and
- receive feedback from yourselves on the performance of the engagement team.

As outlined in our Audit Strategy Memorandum, our audit has been conducted in accordance with International Standards of Auditing (UK and Ireland) which means we focus on audit risks that we have assessed as resulting in a higher risk of material misstatement. Section 2 of this report includes our conclusions on the significant risks and areas of management judgement that we set out in our Audit Strategy Memorandum and Progress Report.

We also set out details of internal control recommendations in section 3 and a summary of misstatements discovered as part of the audit in section 4.

Status and audit opinion

We have substantially completed our audit of the financial statements for the year ended 31 March 2015.

At the time of preparing this report, the following matters remain outstanding:

Area outstanding	Work to be completed
Closure procedures	Completion of our procedures

We will provide an update to you in relation to the matters outstanding above by issuing a follow up letter.

Subject to the satisfactory conclusion of the remaining audit work, we anticipate issuing an unqualified opinion, without modification, on your financial statements.

Our proposed audit report is set out in Appendix B.

02 Significant findings

Set out below are the significant findings from our audit. These findings include:

- our audit conclusions regarding the significant risks outlined in the Audit Strategy Memorandum and July 2015 Progress Report;
- our comments in respect of the accounting policies and disclosures that you have adopted in the financial statements. On page 6 we have concluded whether the financial statements have been prepared in accordance with the financial reporting framework and commented on any significant accounting policy changes that have been made during the year; and
- any significant difficulties we experienced during the audit.

Significant risks and key areas of management judgement

Management override of controls

Description of the risk

In all entities, management at various levels within an organisation are in a unique position to perpetrate fraud because of their ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. Due to the unpredictable way in which such override could occur, we consider there to be a risk of material misstatement due to fraud and thus a significant risk on all audits.

How we addressed this risk

We addressed this risk by performing audit work on:

- accounting estimates impacting material amounts included in the financial statements;
- consideration of identified significant transactions outside the normal course of business;
- consideration of any other local factors;
- journals recorded in the general ledger and other adjustments made in preparation of the financial statements; and
- the year end bank reconciliation.

We also obtained written assurances from the Audit Committee and management on their controls and processes for assessing the risk of fraud in the financial statements and arrangements in place to identify, respond to and report fraud.

Audit conclusion

Our work has provided the assurance we sought and has not highlighted any issues in this area to report.

Valuation of unquoted investments for which a market price is not readily available

Description of the risk

At planning stage we noted that at 31 March 2014 the fair value of investments which were not quoted on an active market was £701m, which accounted for 32% of net investment assets. The values used in the accounts are those provided by fund managers mostly based on Net Asset Value statements, although in some cases are based on forward looking estimates and judgements involving many factors. This results in an increased risk of material misstatement.

How we addressed this risk

In addition to our standard programme of work in this area we completed the following tests:

- reviewed the management controls in place to assess the reasonableness of the valuation;
- agreed holdings from fund manager reports to the global custodian's report;
- agreed the valuation to supporting documentation including investment manager valuation statements and cashflows for any adjustments made to the investment manager valuation;
- agreed the investment manager valuation to audited accounts. Where these were not available, agreed the investment manager valuation to other independent supporting documentation;
- where audited accounts were available, checked that they are supported by a clean opinion; and
- agreed the price to independent evidence, for those valuations not supported by valuation statement.

Audit conclusion

Our work has provided the assurance we sought and has not highlighted any issues in this area to report.

Disclosure of Funding Arrangements

Description of the risk

The funding arrangements disclosure note sets out the key elements of the funding policy and key information regarding the most recent triennial valuation as at 31 March 2013, including contributions to be paid by participating bodies to allow the fund to achieve 100% solvency over 18 years. While there are no accounting entries associated with this disclosure, the triennial valuation determines future employer contribution rates and the disclosure itself is material. The calculation of these figures can be subject to significant volatility and includes estimates based upon a complex interaction of actuarial assumptions. There is a risk of material misstatement due to high estimation uncertainty.

How we addressed this risk

In addition to our standard program of work we:

- reviewed the management controls in place over the source data;
- considered the reasonableness of the Actuary's output, using our expert's report on all actuaries nationally which is commissioned annually by the Audit Commission; and
- reviewed source data on a sample basis.

Audit conclusion

We have identified no matters to report arising from our work on the disclosure of funding arrangements.

Oracle Upgrade

Description of the risk

In July 2014 the Council upgraded the Oracle suite of programs to version R12.1.3. This is a significant upgrade to the General Ledger (and associated modules) during the year with a resulting risk of errors arising during the data conversion process.

How we addressed this risk

We completed the following audit work:

- completed an IT risk assessment;
- assessed managements controls over the conversion process; and
- completed substantive testing to confirm that the data was completely and accurately brought forward into the new environment following the data migration.

Audit conclusion

The required assurance has been obtained that no material misstatements have occurred as a result of the R12 upgrade.

Accounting policies and disclosures

We have reviewed Durham County Council Pension Fund's accounting policies and disclosures and concluded they materially comply with the requirements of the Code of Practice on Local Authority Accounting in the UK 2014/15 ('the Code').

Significant difficulties during the audit

During the course of the audit we did not encounter any significant difficulties and we have had the full co-operation of management.

03 Internal control recommendations

The purpose of our audit is to express an opinion on the financial statements. As part of our audit we considered the internal controls in place relevant to the preparation of the financial statements in order to design audit procedures to allow us to express an opinion on the financial statements but not for the purpose of expressing an opinion on the effectiveness of internal control or to identify any significant deficiencies in their design or operation.

The matters reported are limited to those deficiencies and other control recommendations that we have identified during our normal audit procedures and that we consider to be of sufficient importance to merit being reported. If we had performed more extensive procedures on internal control we might have identified more deficiencies to be reported or concluded that some of the reported deficiencies need not in fact have been reported. Our comments should not be regarded as a comprehensive record of all deficiencies that may exist or improvements that could be made.

We have not identified any significant deficiencies as a result of our work this year that we need to bring to your attention.

IT audit review

The objective of this work was to evaluate the controls in place over the IT environment (applications and underlying infrastructure), by:

- understanding the IT environment, applications, interfaces and related controls; and
- assessing the design and operating effectiveness of the controls in place over the main processes:
  - physical security;
  - backup and disaster recovery;
  - access management and logical security;
  - strategy and internal control; and
  - change management.

Our work concluded that reliance can be placed on the IT General Controls operating over the systems identified as material for the 2014/15 financial audit and the underlying infrastructure.

No significant issues were identified that could have an impact on the financial accounts; however we made improvement recommendations specifically for Pension Fund systems (in addition to those recommended for Council systems used by the Fund) on:

- documenting the process requesting changes to user access, clearly stating the procedures, roles and responsibilities for initiating amendments to user access and introducing a standard form to be used for requests to amend user access;
- considering the implementation of a periodic user review process, focusing on users that have not logged on to the system for more than 90 days and users that no longer require access to the system, or require different access rights; and ensuring that all major steps (change request initiation, authorisation, testing, user acceptance/go-live approval) are documented;
- considering the implementation of a proper segregation of duties between changes development and migration into production tasks; and
- closely monitoring implemented changes in order to ensure no unauthorised changes are deployed into the system.

Relevant action plans have been established by officers in order to address the identified recommendations.

04 Summary of misstatements

We set out below the misstatements identified during the course of the audit.

There have been no non trivial misstatements to the Fund Account or Net Assets Statement that were identified during the course of our audit. There have however been material misstatements to the notes within the Pension Fund statements that have been adjusted by management:

Disclosure amendments

The financial statements have been amended for a number of minor errors, omissions, rounding error corrections, clarifications and typographical errors. The main disclosure note misstatements identified during the course of the audit are outlined below, all of which have been amended by management:

Table 3: Disclosure amendments

Note reference	Error
Note 14: Investments – Reconciliation of Movements in Investments 2014/15	Material misclassifications mainly due to transition transactions being posted as Pooled Investment Vehicles transactions rather than the actual transaction type: Fixed interest purchases - £21.0m increase Fixed interest sale proceeds - £12.6m decrease Equity purchases - £1,965.9m increase Equity sale proceeds - £2,313.5m increase Pooled Investment Vehicle purchases - £2,746.3m decrease Pooled Investment Vehicle sale proceeds - £2,965.6m decrease Derivative contract purchases £1.9m increase Derivative contract sale proceeds - £21.2m decrease Change in market value - other cash deposits - £71.6m decrease
Note 14 – Investments - Assets exceeding 5% of Market Value of Fund	The disclosure requirement is that details of any single investment exceeding either 5% of the net assets available for benefits or 5% of any class or type of security should be disclosed. The former was originally disclosed, but not the latter.

Appendix A – Draft management representation letter

To be provided to us on headed note paper

30 September 2015

Dear Mr Waddell

Durham County Council Pension Fund - audit for year ended 31 March 2015

This representation letter is provided in connection with your audit of the financial statements of Durham County Council Pension Fund (the Pension Fund) for the year ended 31 March 2015 for the purpose of expressing an opinion as to whether the financial statements give a true and fair view in accordance with the Code of Practice on Local Authority Accounting in the United Kingdom 2014/15 (the Code).

I confirm that the following representations are made on the basis of enquiries of management and staff with relevant knowledge and experience (and, where appropriate, inspection of supporting documentation) sufficient to satisfy ourselves that I can properly make each of the following representations to you.

My responsibility for the financial statements and accounting information

I believe that I have fulfilled my responsibilities for the true and fair presentation and preparation of the financial statements in accordance with the Code and relevant legislation and International Financial Reporting Standards.

My responsibility to provide and disclose relevant information

I have provided you with:

- access to all information of which we are aware that is relevant to the preparation of the financial statements such as records, documentation and other material;
- additional information that you have requested from us for the purpose of the audit; and
- unrestricted access to individuals within the Pension Fund you determined it was necessary to contact in order to obtain audit evidence.

I confirm as Corporate Director Resources that I have taken all the necessary steps to make me aware of any relevant audit information and to establish that you, as auditors, are aware of this information.

As far as I am aware there is no relevant audit information of which you, as auditors, are unaware.

Accounting records

I confirm that all transactions that have a material affect on the financial statements have been recorded in the accounting records and are reflected in the financial statements. All other records and related information, including minutes of all Committee meetings, have been made available to you.

Accounting policies

I confirm that I have reviewed the accounting policies applied during the year in accordance with the Code and International Accounting Standard 8 and consider these policies to faithfully represent the effects of transactions, other events or conditions on the Pension Fund's financial position, financial performance and cash flows

Accounting estimates, including those measured at fair value

I confirm that any significant assumptions used by the Pension Fund in making accounting estimates, including those measured at fair value, are reasonable. I confirm that disclosures related to accounting estimates are complete and that no subsequent event requires adjustment to the accounting estimates and disclosures included in the financial statements.

Contingencies

There are no material contingent losses including pending or potential litigation that should be accrued where:

- information presently available indicates that it is probable that an asset has been impaired or a liability had been incurred at the balance sheet date; and
- the amount of the loss can be reasonably estimated.

There are no material contingent losses that should be disclosed where, although either or both the conditions specified above are not met, there is a reasonable possibility that a loss, or a loss greater than that accrued, may have been incurred at the balance sheet date.

All material matters, including unasserted claims, that may result in litigation against the Pension Fund have been brought to your attention. All known actual or possible litigation and claims whose effects should be considered when preparing the financial statements have been disclosed to you and accounted for and disclosed in accordance with the Code and relevant legislation and International Financial Reporting Standards (IFRSs).

Laws and regulations

I confirm that I have disclosed to you all those events of which I am aware which involve known or suspected non-compliance with laws and regulations, together with the actual or contingent consequences which may arise therefrom.

I confirm the Pension Fund has complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of non-compliance.

Fraud and error

I acknowledge my responsibility as Corporate Director Resources for the design, implementation and maintenance of internal control to prevent and detect fraud and error.

I have disclosed to you:

- all the results of my assessment of the risk that the financial statements may be materially misstated as a result of fraud;
- all knowledge of fraud or suspected fraud affecting the Pension Fund's financial statements involving:
    - management and those charged with governance;
    - employees who have significant roles in internal control; and
    - others where fraud could have a material effect on the financial statements.

I have disclosed to you all information in relation to any allegations of fraud, or suspected fraud, affecting the Pension Fund's financial statements communicated by employees, former employees, analysts, regulators or others.

Related party transactions

I confirm that all related party relationships, transactions and balances, have been appropriately accounted for and disclosed in accordance with the requirements of the Code and relevant legislation and International Financial Reporting Standards.

I have disclosed to you the identity of the Pension Fund's related parties and all related party relationships and transactions of which I am aware.

Future commitments

I am not aware of any plans, intentions or commitments that may materially affect the carrying value or classification of assets and liabilities or give rise to additional liabilities.

Subsequent events

I confirm all events subsequent to the date of the financial statements and for which the Code, relevant legislation and International Financial Reporting Standards require adjustment or disclosure have been adjusted or disclosed.

Should further material events occur after the date of this letter which may necessitate revision of the figures included in the financial statements or inclusion of a note thereto, I will advise you accordingly.

Going concern

To the best of my knowledge there is nothing to indicate that the Pension Fund will not continue as a going concern in the foreseeable future. The period to which I have paid particular attention in assessing the appropriateness of the going concern basis is not less than twelve months from the date of approval of the financial statements.

Specific representation on unquoted investments

Unquoted investments are included in the net assets statement at the value provided by our fund managers which have been estimated in accordance with the guidelines used by the industry, and based on the latest information to hand at the time of the valuation. I am satisfied, based on the knowledge I have, with the valuations, and am not aware of any subsequent events that would have a material impact on the estimated value of the unquoted investments.

Signed

For and on behalf of Durham County Council.

Appendix B – Draft audit report

INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF DURHAM COUNTY COUNCIL

Opinion on the Council's financial statements

We have audited the financial statements of Durham County Council for the year ended 31 March 2015 under the Audit Commission Act 1998. The financial statements comprise the Movement in Reserves Statement, the Comprehensive Income and Expenditure Statement, the Balance Sheet, the Cash Flow Statement and Collection Fund and the related notes. The financial reporting framework that has been applied in their preparation is applicable law and the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom 2014/15.

This report is made solely to the members of Durham County Council in accordance with Part II of the Audit Commission Act 1998 and for no other purpose, as set out in paragraph 48 of the Statement of Responsibilities of Auditors and Audited Bodies published by the Audit Commission in March 2010. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Council and the Council's members as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of the Corporate Director Resources and auditor

As explained more fully in the Statement of the Corporate Director Resources Responsibilities, the Corporate Director Resources is responsible for the preparation of the Statement of Accounts, which includes the financial statements, in accordance with proper practices as set out in the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom, and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland).Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the Council's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the Corporate Director Resources; and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the explanatory foreword to identify material inconsistencies with the audited financial statements. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

Opinion on financial statements

In our opinion the financial statements:

- give a true and fair view of the financial position of Durham County Council as at 31 March 2015 and of its expenditure and income for the year then ended; and
- have been prepared properly in accordance with the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom 2014/15.

Opinion on other matters

In our opinion, the information given in the explanatory foreword for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which we report by exception

We report to you if:

- in our opinion the annual governance statement does not reflect compliance with 'Delivering Good Governance in Local Government: a Framework' published by CIPFA/SOLACE in June 2007 and the December 2012 addendum;
- we issue a report in the public interest under section 8 of the Audit Commission Act 1998;

- we designate under section 11 of the Audit Commission Act 1998 any recommendation as one that requires the Council to consider it at a public meeting and to decide what action to take in response; or
- we exercise any other special powers of the auditor under the Audit Commission Act 1998.

We have nothing to report in these respects.

Opinion on the Pension Fund financial statements

We have audited the pension fund financial statements for the year ended 31 March 2015 under the Audit Commission Act 1998. The Pension Fund financial statements comprise the Fund Account, the Net Assets Statement and the related notes. The financial reporting framework that has been applied in their preparation is applicable law and the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom 2014/15.

This report is made solely to the members of Durham County Council in accordance with Part II of the Audit Commission Act 1998 and for no other purpose, as set out in paragraph 48 of the Statement of Responsibilities of Auditors and Audited Bodies published by the Audit Commission in March 2010. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Council and the Council's members as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of the Corporate Director Resources and auditor

As explained more fully in the Statement of the Corporate Director Resources Responsibilities, the Corporate Director Resources is responsible for the preparation of the Statement of Accounts, which includes the Pension Fund financial statements, in accordance with proper practices as set out in the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom, and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the fund's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the Corporate Director Resources; and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the explanatory foreword to identify material inconsistencies with the audited financial statements. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for my report.

Opinion on Pension Fund financial statements

In our opinion the Pension Fund's financial statements:

- give a true and fair view of the financial transactions of the pension fund during the year ended 31 March 2015 and the amount and disposition of the fund's assets and liabilities as at 31 March 2015 other than liabilities to pay pensions and other benefits after the end of the scheme year; and
- have been properly prepared in accordance with the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom 2014/15.

Opinion on other matters

In our opinion, the information given in the explanatory foreword for the financial year for which the financial statements are prepared is consistent with the financial statements.

Conclusion on the Council's arrangements for securing economy, efficiency and effectiveness in the use of resources

Respective responsibilities of the Council and the auditor

The Council is responsible for putting in place proper arrangements to secure economy, efficiency and effectiveness in its use of resources, to ensure proper stewardship and governance, and to review regularly the adequacy and effectiveness of these arrangements.

We are required under Section 5 of the Audit Commission Act 1998 to satisfy ourselves that the Council has made proper arrangements for securing economy, efficiency and effectiveness in its use of resources. The Code of Audit Practice issued by the Audit Commission requires us to report to you our conclusion relating to proper arrangements, having regard to relevant criteria specified by the Audit Commission.

We report if significant matters have come to our attention which prevent us from concluding that the Council has put in place proper arrangements for securing economy, efficiency and effectiveness in its use of resources. We are not required to consider, nor have we considered, whether all aspects of the Council's arrangements for securing economy, efficiency and effectiveness in its use of resources are operating effectively.

Scope of the review of arrangements for securing economy, efficiency and effectiveness in the use of resources

We have undertaken our audit in accordance with the Code of Audit Practice, having regard to the guidance on the specified criteria, published by the Audit Commission, as to whether the Council has proper arrangements for:

- securing financial resilience; and
- challenging how it secures economy, efficiency and effectiveness.

The Audit Commission has determined these two criteria as those necessary for us to consider under the Code of Audit Practice in satisfying ourselves whether the Council put in place proper arrangements for securing economy, efficiency and effectiveness in its use of resources for the year ended 31 March 2015.

We planned our work in accordance with the Code of Audit Practice. Based on our risk assessment, we undertook such work as we considered necessary to form a view on whether, in all significant respects, the Council had put in place proper arrangements to secure economy, efficiency and effectiveness in its use of resources.

Conclusion

On the basis of our work, having regard to the guidance on the specified criteria published by the Audit Commission, we are satisfied that, in all significant respects, Durham County Council put in place proper arrangements to secure economy, efficiency and effectiveness in its use of resources for the year ended 31 March 2015.

Certificate of audit completion

We certify that we have completed the audit of the accounts of Durham County Council in accordance with the requirements of the Audit Commission Act 1998 and the Code of Audit Practice issued by the Audit Commission.

[Signature]

Cameron Waddell CPFA

For and on behalf of Mazars LLP, Appointed Auditors

The Rivergreen Centre
Aykley Heads
Durham
DH1 5TS

30 September 2015

Appendix C – Draft consistency report

INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF DURHAM COUNTY COUNCIL ON THE PENSION FUND FINANCIAL STATEMENTS

We have examined the pension fund financial statements for the year ended 31 March 2015, which comprise the Fund Account, the Net Assets Statement and the related notes.

This report is made solely to the members of Durham County Council in accordance with Part II of the Audit Commission Act 1998 and for no other purpose, as set out in paragraph 48 of the Statement of Responsibilities of Auditors and Audited Bodies published by the Audit Commission in March 2010. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Council and the Council's members as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of the Corporate Director Resources and the auditor

As explained more fully in the Statement of the Corporate Director Resources Responsibilities, the Corporate Director Resources is responsible for the preparation of the pension fund's financial statements in accordance with applicable United Kingdom law.

Our responsibility is to report to you our opinion on the consistency of the pension fund financial statements within the pension fund annual report with the pension fund financial statements in the statement of accounts of Durham County Council, and its compliance with applicable law and the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom 2014/15.

We also read the other information contained in the pension fund annual report and consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the pension fund financial statements.

We conducted our work in accordance with guidance issued by the Audit Commission. Our report on the administering authority's full annual statement of accounts describes the basis of our opinion on those financial statements.

Opinion

In our opinion, the pension fund financial statements are consistent with the full annual statement of accounts of Durham County Council for the year ended 31 March 2015 and comply with applicable law and the CIPFA/LASAAC Code of Practice on Local Authority Accounting in the United Kingdom 2014/15.

[Signature]

Cameron Waddell CPFA

For and on behalf of Mazars LLP, Appointed Auditors

The Rivergreen Centre
Aykley Heads
Durham
DH1 5TS

30 September 2015

Appendix D – Independence

As part of our ongoing risk assessment we monitor our relationships with you to identify any new actual or perceived threats to our independence within the regulatory or professional requirements governing us as your auditors.

We can confirm that no new threats to independence have been identified since issuing the Audit Strategy Memorandum and therefore we remain independent.

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MAZARS

Members of the Audit Committee
Durham County Council
County Hall
Durham
DH15UE

Direct line +44 (0)191 383 6314
Email cameron.waddell@mazars.co.uk

30 September 2015

Dear Members

Conclusion of pending matters – Durham County Council Pension Fund Audit Completion Report

As required by International Standards on Auditing (UK and Ireland), I am writing to communicate an update on those matters that were marked as outstanding within our Audit completion report dated 30 September 2015.

The outstanding matters identified and the current status of each are detailed below.

Outstanding matter	**Conclusion reached**
Completion of our review procedures and checking the revised statement of accounts.	Some minor changes identified to disclosure notes which have been adjusted by management. In addition, the first adjustment on page 8 of our audit completion report also resulted in an adjustment to the Net Gains and Losses on Financial Instruments table in note 15 to the accounts. The impact has been to increase the gain attributable to Fair Value through profit and loss by £71.606m, reduce the gain attributable to loans and receivables by £71.438m, and increase the total gain by £0.168m.

If you wish to discuss these or any other points then please do not hesitate to contact me.

Yours faithfully

Cameron Waddell

Mazars LLP

cc Mr Don McLure, Corporate Director Resources

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Agenda Item 16

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Agenda Item 22

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