Northumberland County Council

MEETING OF THE PENSION FUND PANEL

24 FEBRUARY 2017

REPORT OF THE CHIEF EXECUTIVE

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1. Investment Strategy Statement

Purpose of the report

This report seeks Panel approval of NCC's first LGPS Investment Strategy Statement.

Recommendation

The Panel is requested to:

(i) approve the NCC LGPS Investment Strategy Statement attached as Appendix 3 to this report; and

(ii) delegate authority to the Chief Executive in consultation with the Chairman and Vice Chairman of the Panel to make any further changes required to the Statement as a result of the consultation with the participating employers and trade unions.

Key issues

1.1 The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 came into force in November 2016 and require administering authorities to have an Investment Strategy Statement (ISS) in place, with the first to be published by 1 April 2017. The requirement to have an ISS replaces the requirement contained in the 2009 LGPS Investment Regulations to have a Statement of Investment Principles (SIP) in place.

1.2 The 2016 Investment Regulations remove the prescribed limits on types and weightings of investments to be held in LGPS funds contained in the (now revoked) 2009 Investment Regulations. Instead of complying with limits, each authority must describe in the ISS the authority's approach to investing. The administering authority must invest in a "wide variety" of investments, and the ISS must set out the approach to matters such as risk, pooling, environmental, social and corporate governance issues and exercise of voting rights. The ISS must comply with DCLG's guidance issued in September 2016, attached as **Appendix 2**, and the authority must take "proper advice" before preparing it and review at least every three years.

1.3 The 2016 Investment Regulations bring in Regulation 8, which allows the Secretary of State to intervene directly in the investment management of a LGPS fund in the event that an administering authority fails to act in accordance with DCLG's guidance. This is widely interpreted as meaning that the Secretary of State will intervene, if necessary, to ensure all LGPS funds commit to a pooling arrangement.

1. Investment Strategy Statement

BACKGROUND

NCC Pension Fund's Statement of Investment Principles

1.4 The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 required administering authorities to have a Statement of Investment Principles (SIP) in place. NCC Pension Fund's SIP was reviewed at least annually and last updated and approved at the February 2016 meeting of the Panel.

The 2016 Investment Regulations

1.5 The 2009 Investment Regulations were revoked and replaced by the 2016 Investment Regulations, with effect from 1 November 2016. The 2016 Investment Regulations introduce a requirement to formulate an Investment Strategy Statement (ISS) which, in effect, replaces the requirement to have a SIP in place.

1.6 The requirements of the ISS and SIP are very similar. Unlike the 2009 Investment Regulations, the 2016 Investment Regulations do not set **prescribed limits** for the type of investments which LGPS funds may hold or the weighting of different asset classes within the investment portfolio. Instead of complying with limits, under Regulation 7, each administering authority will be required, in the ISS, to **outline its approach** to investing. Certain parameters are set out in the Regulations, for example, the ISS must include a requirement to invest in a "wide variety" of investments, and must set out the authority's approach to matters such as risk, pooling of investments, environmental, social and corporate governance (ESG) considerations and the exercise of voting rights.

1.7 The ISS must comply with DCLG's guidance, and the authority must take "proper advice" when preparing it. The first ISS must be published by **1 April 2017** and there is a requirement to review and revise it at least every **three** years.

1.8 The most controversial provision in the consultation process was Regulation 8, which allows the Secretary of State to intervene **directly** in the investment management of a LGPS fund in the event that an administering authority fails to act in accordance with the Secretary of State's guidance. Further details of the Secretary of State's powers of intervention are set out in an Eversheds Speed Brief, attached as **Appendix 1** to this report.

1.9 The Secretary of State's Guidance on preparing and maintaining an investment strategy statement was issued **15 September 2016** and is attached as **Appendix 2** to this report.

1.10 The 2016 Investment Regulations provide a prudential framework within which the investment strategy can be implemented and managed, rather than the more prescriptive approach that was previously in place. The extra freedom given to administering authorities comes with the quid pro quo of greater power of intervention given to DCLG.

1.11 The Guidance on preparing and maintaining an investment strategy statement includes the requirement that all authorities must commit to a suitable pool to achieve benefits of scale. Administering authorities must confirm their chosen investment pool meets the investment reform and **criteria** published in **November 2015**, or that they have received confirmation from Government to continue with pooling proposals that do not. The November 2015 criteria states that authorities must submit **proposals** which describe pooling arrangements which "*have regard to"* each of four criteria, namely:

- A. Asset pool(s) that achieve the benefits of scale;
- B. Strong governance and decision making;
- C. Reduced costs and excellent value for money; and
- D. An improved capacity to invest in infrastructure.

1.12 Members will recall that NCC Pension Fund's chosen pooling arrangement, BCPP, received confirmation from Government in December 2017 that its pooling proposal (submitted to Government in July 2016) meets the November 2015 criteria.

<u>Requirement to formulate and publish an ISS</u>

1.13 The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 require each administering authority to formulate and publish a statement of its investment strategy.

1.14 Regulation 7 of the LGPS (Management and Investment of Funds) Regulations 2016 sets out:

"Investment strategy statement

7.—(1) An authority must, after taking proper advice, formulate an investment strategy which must be in accordance with guidance issued from time to time 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 assessed 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 and 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(**1**).

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

(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 April 2017.

(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."

Approval and consultation

1.15 NCC Pension Fund's first *draft* ISS is attached as **Appendix 3** to this report. Members are asked to review and approve the draft ISS for consultation.

1.16 The authority must **consult** over the ISS with "persons it considers appropriate", therefore, following Panel approval for the draft ISS at this meeting, the Fund's participating employers and relevant trade unions will be consulted. This report seeks delegated authority to the Chief Executive in consultation with the Chairman and Vice Chairman of the Panel to amend the ISS, if appropriate, as a result of comments received from the consultation process.

1.17 Any **significant** revisions to the ISS, following consultation, will be brought back to the Panel meeting on 31 March 2017, for information.

Advice taken and collaboration on drafting the ISS

1.18 The draft ISS (at Appendix 3) has been prepared by officers with advice from the Fund's adviser, Mercer.

1.19 Officers in the Border to Coast Pensions Partnership (BCPP) Officer Operations Group (OOG) have also collaborated on part of the drafting of each administering authority's ISS, to ensure consistency in the references made to the approach to pooling.

1.20 Officers have consulted with the Fund's investment managers on the draft ISS.

Investment objective

1.21 The draft ISS incorporates the Fund's investment objective, agreed at the meeting of the Panel held on 26 February 2016.

UK Stewardship Code

1.22 The Secretary of State's Guidance (at Appendix 2) includes:

"Administering authorities are encouraged to consider the best way to engage with companies to promote their long-term success, either directly, in partnership with other investors or through their investment managers, and explain their policy on stewardship with reference to the Stewardship Code. Administering authorities should become Signatories to the Code and state how they implement the seven principles and guidance of the Code, which apply on a "comply or explain" basis."

1.23 NCC Pension Fund is not a signatory to the UK Stewardship Code. The Code can be accessed from:
https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Stewardship-Code.aspx.
The Code originally applied only to investment managers, and the Fund's sole investment manager with responsibility for investing public equities on the Fund's behalf, Legal and General, has been a signatory to the Code since it was introduced in 2010. Legal and General's response to the Stewardship Code, dated November 2016, is shown at:
http://www.lgim.com/library/capabilities/UK_Stewardship_Code.pdf.

1.23 In an email dated 4 November 2016 from Hannah Armitage of the Financial Reporting Council UK (FRC) to Jane Firth of South Yorkshire Pensions Authority, Hannah confirms:

"We have interpreted the Guidance to mean that funds should explain their policy on stewardship with reference to the Stewardship Code where they consider that appropriate to their approach – presumably following on from the first point, which requires explanation for not having a policy on voting rights etc. However, we don't expect all funds to necessarily sign up, as it will be up to each of them to decide what is most relevant to them."

1.24 Some administering authorities within the BCPP group of funds are already signatories to the UK Stewardship Code, and there is an item in the Fund's 2017 Action Plan (which will be brought to the 31 March 2017 Panel meeting) for the Panel to consider becoming a signatory to the Code in 2017/2018. The Fund's draft ISS refers to the intention to consider signing up to the Code.

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2. Legal and General's Corporate Governance and Responsible Investment Policy

Purpose of the report

This report seeks Panel approval to continue to endorse Legal and General's Corporate Governance and Responsible Investment Policy.

Recommendation

The Panel is requested to review and endorse Legal and General's Corporate Governance and Responsible Investment Policy, enclosed with these papers and summarised in Appendix 4.

Key issues

2.1 The NCC Pension Fund's first draft Investment Strategy Statement (ISS), attached as **Appendix 3** to this report, refers to the Panel endorsing Legal and General's corporate governance and share voting policy. The Fund's Statement of Investment Principles (i.e. the forerunner to the ISS), last approved by the Panel in February 2016, contained a similar endorsement of L&G's policy.

2.2 Therefore, periodic review by the Panel of L&G's policy is appropriate, and the purpose of this report is to seek continued endorsement of the policy by the Panel. L&G's 2016 "***Corporate Governance and Responsible Investment Policy*"** is **enclosed** with these papers, together with L&G's paper "***LGPS Intelligence, We're engaged***" which sets out the benefits for clients of using an experienced asset manager for stewardship and engagement activities. L&G reviews its corporate governance policy annually. The next review by the Panel of L&G's policy will be scheduled to take place in three years.

2.3 Taking the approach of endorsing L&G's corporate governance policy is a practical and cost effective way for NCC Pension Fund to exercise its rights as a shareholder. L&G's interests should be fully aligned with clients' as both seek to enhance long term shareholder value. It is important that stewardship and governance activities are implemented in an informed manner, and the asset manager itself is likely to be best placed to undertake these activities.

2. Legal and General's Corporate Governance and Responsible Investment Policy

BACKGROUND

2.4 The NCC Pension Fund's first draft Investment Strategy Statement (ISS), attached as **Appendix 3** to this report, refers to the Panel endorsing Legal and General's corporate governance and share voting policy. The Fund's Statement of Investment Principles (i.e. the forerunner to the ISS), last approved by the Panel in February 2016, contained a similar endorsement of L&G's policy.

2.5 Page 10 of Appendix 3 sets out:

"*The exercise of rights (including voting rights) attaching to investments*

Voting rights
The Panel has delegated the exercise of voting rights to Legal and General with a requirement to:

- *follow Legal and General's own share voting policy for all public equities except the FTSE 350 companies; and*
- *follow PIRC's share voting advice for the Fund's effective shareholding in the FTSE 350 UK companies.*

The Panel reviews PIRC's and Legal and General's share voting policies periodically. The Panel considers that the Fund's and Legal and General's interests are aligned, as both seek to enhance long term shareholder value.

The Fund encourages Legal and General to vote shares in all markets, where practical.

Stewardship
In 2017/2018, the Panel will consider the Fund becoming a signatory to the UK Stewardship Code. The Panel also requires Legal and General to comply with the Code.

The Fund is a member of the Local Authority Pension Fund Forum (LAPFF) through which it collectively exercises a voice across a range of corporate governance issues."

In relation to the Fund's "***Social, environmental and corporate governance policy***" Page 9 of Appendix 3 also sets out that:

- *"the Fund's public equity investment manager's policy on corporate governance and use of voting rights is reviewed by the Panel periodically.*"

2.6 Delegating share voting to Legal and General (L&G) for all equity holdings other than the FTSE 350 is a practical and cost effective way of exercising the Fund's voting rights. It also has the advantage of helping L&G leverage its scale as one of Europe's largest asset managers to make its (and therefore NCC Pension Fund's) voice, as a shareholder, heard.

2.7 Researching companies and voting shares is a very resource-intensive activity, and L&G has an experienced team, dedicated to doing this work.

2.8 In terms of use of shareholder rights to help enhance long term value of the companies owned, passive managers' interests could be said to be ***more*** aligned with clients' interests than active managers, as they cannot "vote with their feet" and sell the shares held. Instead, they must make their vote (and other forms of engagement) count and try and change company behaviour where necessary.

2.9 L&G's 2016 "***Corporate Governance and Responsible Investment Policy***" is **enclosed** with these papers, for Panel members to consider. A summary of L&G's policy is attached as **Appendix 4** to this report. L&G reviews its policy annually to reflect changes in best practice and changes in corporate behaviour.

2.10 A further L&G paper, dated December 2016, entitled "***LGPS Intelligence, We're Engaged***" is **enclosed** with these papers. This explains the benefit of effective stewardship to investors and puts the case for active and informed **engagement** with companies. It also points out (on page 7) the problem with split voting, of the type NCC Pension Fund requires in order to overlay L&G's share voting policy with PIRCs for the FTSE 350 companies.

2.11 Engagement with companies is an important part of stewardship, and very resource intensive. For this reason, LAPFF only engages with a small number of companies in any year. L&G's approach, is to integrate engagement with its share voting activities.

2.12 L&G is a signatory to both:
- the UK Stewardship Code achieving "Tier 1" compliance; and
- the United Nations-supported Principles for Responsible Investment (PRI), which is similar to the UK Stewardship Code.

<u>Endorse L&G's share voting and corporate governance policy</u>

2.13 As noted in paragraph 2.5 above, NCC Pension Fund has delegated share voting to L&G with an instruction to follow its own share voting policy (and PIRC's policy for the FTSE 350). Therefore, the Panel must periodically consider and endorse L&G's share voting policy.

2.14 The Panel must also consider L&G's wider corporate governance policy, as set out in the enclosed Corporate Governance and Responsible Investment Policy, as successful stewardship of companies owned requires more than just voting shares.

2.15 As part of the initial work done by officers in the Border to Coast Pensions Partnership (BCPP) Officer Operations Group (OOG) to establish a share voting policy to be adopted by all funds in the collaboration, a number of corporate governance policies have been compared, including L&G's. A good deal more still work still needs to be done to arrive at a consensus policy for BCPP Ltd, but one option which has not been ruled out is adopting something similar to L&G's policy for BCPP Ltd.

2.16 Others in the BCPP group of funds that also have L&G as passive manager are Bedfordshire, Cumbria, Surrey, Teesside, Tyne and Wear and Warwickshire. They all take a similar approach to NCC and endorse (at least part of) L&G's share voting policy. Lincolnshire will soon become a client of L&G's passive management too.

2.17 Mercer's ESG Team has provided the following view of L&G's policy:

> "In Mercer's view, LGIM's voting policy is comprehensive and well developed. LGIM has also adapted its core Corporate Governance General Policy into regional specific policies, in order to capture regional nuances. The policies clearly set out LGIM's position on key issues, including: company board composition, company structure and operation (such as diversity, independence, re-election, board nominations, board size, board mandates), accountability, remuneration and shareholder rights. In addition, LGIM has a standalone policy on climate change. LGIM regularly reviews its policies to ensure these remain up to date and capture relevant issues. Development and implementation of the policies is undertaken by the Corporate Governance team with oversight provided by a separate Corporate Governance Board. In Mercer's view there is a strong consistency between LGIM's stated voting policy and the resulting implementation in terms of votes cast and engagement activities undertaken. Engagement is comprehensive and LGIM is prepared to escalate its activities as required and frequently collaborates with other investors. In Mercer's view, LGIM demonstrates best practice compliance with the UK Stewardship Code in undertaking voting and engagement activities on behalf of its clients."

2.18 Therefore, at this meeting, the Panel is requested to review and endorse L&G's corporate governance policy. A further review will be scheduled to take place in three years.

<u>PIRC's engagement as provider of share voting advice</u>

2.19 PIRC's share voting policy is also reviewed and endorsed by the Panel periodically. There is an item in the Fund's 2017 Action Plan (which will be brought to the 31 March 2017 Panel meeting) for the Panel to consider PIRC's share voting policy and/or review PIRC's appointment in 2017/2018. The timing of such a review may be coordinated with other administering authorities within the BCPP group.

2.20 The use of an overlay share voting policy is becoming increasingly problematic, as noted in the enclosed L&G paper "*LGPS Intelligence, We're engaged*".

<u>Responsible investment policy for BCPP Ltd</u>

2.21 There is an intention to arrive at a single share voting/responsible investment (RI) policy for BCPP Ltd, which can be adopted by all funds in the BCPP group. Work will start on this during 2017, though it may take some time to complete. Eleven out of twelve of the administering authorities within the BCPP group are now members of LAPFF, and LAPFF membership will form a key part of the RI policy.

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3. Local Authority Pension Forum (LAPFF) 2017/2018 draft work plan

Purpose of the report

The purpose of this report is to provide information to the Panel about the 2017/2018 LAPFF draft work plan.

Recommendation

The Panel is requested to accept the report.

Key issues

3.1 Members will recall that NCC has recently become a member of LAPFF, committing to a membership until 31 March 2018.

3.2 On 6 February 2017, LAPFF sent members the draft work plan for 2017/2018, asking for comments. The draft work plan is attached as **Appendix 5** to this report.

3.3 The attached work plan sets out the topics LAPFF intends to explore in the year to 31 March 2018. It includes some of the "old favourites" for the Forum such as executive pay, as well as some new topics such as reliable accounts, which was new to the forum in 2015.

3.4 The work plan has been brought to this meeting of the Panel to give members a flavour of the work undertaken by LAPFF.

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4. Reporting breaches: progress and quarterly monitoring report

Purpose of the report

This report provides information about breaches of the law which have occurred in the quarter to 31 December 2016.

Recommendation

The Panel is requested to accept the report.

Key issues

4.1 Oversight of the LGPS by the Pensions Regulator (tPR) with effect from 1 April 2015 brought with it the requirement for administering authorities to enforce the LGPS Regulations and supporting law and guidance more assiduously than before due to the requirement to record and (potentially) report all breaches of LGPS Regulations. Since April 2015, NCC has **reported** some breaches of the law to the Panel on a quarterly basis and considered whether each **recorded** breach is *of material significance to the Regulator* and should be **reported to tPR**.

4.2 Since 1 April **2015**, all breaches in relation to contributions receivable, pensionable pay information and ABSs have been reported to the Panel. Since 1 April **2016**, all other known breaches have also been reported to the Panel.

4.3 In the quarter to 31 December 2016 there were no breaches of the requirement to pay contributions within 19 days of the month end.

4.4 Following advice taken from Karen McWilliam of Aon Hewitt in August 2016, the Pensions Administration Team began its current method of recording all known breaches, effective from 1 April 2016.

4.5 The following records of breaches for the Pensions Administration Team are **enclosed** for the:

- quarter ended 31 December 2016 (an A3 spreadsheet), showing all breaches in the quarter;
- quarter ended 30 September 2016 (a separate A3 spreadsheet), showing all brought forward breaches that had not been resolved when reported to the November 2016 Panel meeting; and
- quarter ended 30 June 2016 (a separate A3 spreadsheet), showing all brought forward breaches that had not been resolved when reported to the September or November 2016 Panel meetings.

4. Reporting breaches: progress and quarterly monitoring report

BACKGROUND

4.6 Oversight of the LGPS by the Pensions Regulator (tPR) with effect from 1 April 2015 brought with it the requirement for administering authorities to enforce the LGPS Regulations and supporting law and guidance more assiduously than before due to the new requirement to record and (potentially) report all breaches of LGPS Regulations.

4.7 Since April 2015, NCC has reported some breaches of the law to the Panel on a **quarterly** basis and considered whether each breach is *of material significance to the Regulator* and should be **reported to the Regulator.** The breaches reported to the Panel form the Northumberland County Council Pension Fund's **breaches log**. These breaches are **recorded** so the Panel can assess whether, in its view, any item is of material significance to tPR and should be reported to tPR.

4.8 A NCC Pension Fund Breaches Procedure was approved at the September 2015 meeting of the Pension Fund Panel, applicable with effect from 1 April 2015. Breaches occurring in the quarter to 30 June 2015 (only in relation to contributions and pensionable pay information) were reported to the September 2015 Panel.

<u>Breaches in relation to contributions and provision of Annual Benefit Statements</u>

4.9 From 1 April 2015 all known breaches in relation to contributions receivable, pensionable pay information and Annual Benefit Statements (ABSs) have been recorded in the breaches log and reported to the Panel. To date, none of the recorded breaches have been viewed as being of material significance to tPR, so none have been reported to the Regulator.

4.10 The Panel *and* Board has given careful consideration to reporting the breaches in issuing the 2014/2015 ABSs and 2015/2016 ABSs by their respective 31 August deadlines, and after taking all relevant information into account.

4.11 Information about breaches in relation to issuing the 2015/2016 ABSs for deferred pensioners and for councillor members was tabled and discussed at the September 2016 Panel meeting.

4.12 At the Board meeting held on 3 November 2016, the Board considered the 2015/2016 ABS breaches in detail concluding that they were not reportable to tPR on this occasion, and made detailed recommendations and comments to the Scheme Manager which were reported to the November 2016 Panel meeting.

<u>Breaches in relation to pensions administration</u>

4.13 As a result of staffing issues in the Pensions Administration Team, recording breaches in the log did not begin until the quarter ended 30 June 2016.

4.14 In August 2016, after taking advice from Karen McWilliam of Aon Hewitt, Clare Gorman consulted with the Chairman and Vice Chairman of the Panel to obtain authority to:

- start the process of full breaches recording from the quarter ended 30 June 2016, rather than backdating; and
- include in the breaches log any breaches the Pensions Administration Team is aware of from earlier periods if they have not already been fully resolved.

4.15 The Chairman and Vice Chairman were supportive of this approach, noting that the most important part of the breaches procedure is recognising as quickly as possible that there has been a breach; ensuring that it has been corrected on a timely basis with no detriment to any LGPS member; and that any system failures are quickly addressed.

4.16 The following records of breaches for the Pensions Administration Team are **enclosed** for the:

- quarter ended 31 December 2016 (an A3 spreadsheet), showing all breaches in the quarter;
- quarter ended 30 September 2016 (a separate A3 spreadsheet), showing all brought forward breaches that had not been resolved when reported to the November 2016 Panel meeting; and
- quarter ended 30 June 2016 (a separate A3 spreadsheet), showing all brought forward breaches that had not been resolved when reported to the September or November 2016 Panel meetings.

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5. Centre for Policy Studies' Report: The *LGPS: A Lost Decade*

Purpose of the report

This report provides information about the Centre for Policy Studies' report "*The LGPS: A Lost Decade*", published in February 2017, in which the author, Michael Johnson, a seasoned critic of the LGPS, calls for a dramatic simplification of the LGPS.

Recommendation

The Panel is requested to accept the report.

Key issues

5.1 The Centre for Policy Studies (CPS) published a report about the LGPS on 1 February 2017, entitled "The LGPS: A Lost Decade". The CPS report is **enclosed** with these papers.

5.2 The CPS report by author Michael Johnson, a seasoned critic of the LGPS, follows recent CPS papers entitled "The LGPS: Unsustainable" and "LGPS 2018" and reveals that, over the last decade, LGPS assets have under-performed the major UK and global equity indices with the only 'winner' being the industry, garnering over £4.5 billion in *reported* fees. In addition, the paper also estimates *unreported* fees to be between £3.6 billion and £4.6 billion.

5.3 The CPS Report also surmises that individual LGPS Funds 'exhibit an extraordinary range' of total annual costs per member, ranging from Enfield's £592 per member in 2015/16 to West Yorkshire's £28 per member for the same year. This leads the author to conclude that, generally, the larger the fund or the more assets managed in-house, the lower the cost per member. This, according to the CPS report, provides further evidence to suggest that a dramatic simplification of the LGPS is required, with the localism aspect of the LGPS swept away to leave just asset pools and specialist investment vehicles and, ultimately, the Government being in a position to set up one infrastructure-focused sovereign wealth fund.

5.4 The CPS report has been met with a fairly muted response by the industry as a whole.

5. Centre for Policy Studies' Report: The *LGPS: A Lost Decade*

BACKGROUND

Report published February 2017

5.5 The Centre for Policy Studies (CPS) published a report about the LGPS on 1 February 2017, entitled "The LGPS: A Lost Decade". The CPS report is **enclosed** with these papers.

5.6 The CPS report by author Michael Johnson, a seasoned critic of the LGPS, follows recent CPS papers entitled "The LGPS: Unsustainable" and "LGPS 2018", and suggests that, over the last decade, LGPS assets have under-performed the major UK and global equity indices, and states that passive investing over the same period would have been more rewarding.

5.7 The CPS report suggests that the industry itself has been the only real winner out of this sector wide preference for active equity investing in the last decade, garnering over £4.5 billion in *reported* fees which, as a percentage of assets' market value, have more than *doubled* over the decade. In addition, the paper estimates that *unreported* fees could total between £3.6 billion and £4.6 billion, giving rise to the expected headline-grabbing article the following day in CIPFA's Public Finance magazine which read "LGPS fund manager fees could be £9 billion, says CPS." The CPS report proposes that fees should be predominantly performance-driven, rather than a percentage of assets under management.

5.8 The CPS report outlines that, in 2015/16, the 89 LGPS funds reported total costs per member of £178. This reflects a 110% increase over the last decade; however the report highlights the 'extraordinary diversity' between individual funds, with Enfield's £592 per member being over 20 times larger than West Yorkshire's total cost per member of £28. The report observes a clear negative correlation between costs per member and fund size, with the ten lowest cost funds holding assets four times larger, on average, than the average assets of the ten most costly funds. Generally, according to the report, the larger the fund or the more assets managed in-house, the lower the cost per member.

5.9 The CPS report also considers the price the LGPS has paid for its localism-centred approach, stating that the 89 LGPS funds in England & Wales and their operational overheads, which are primarily a legacy of history, have 'consequently led to the structure of the LGPS becoming an ineffective and inefficient bureaucracy riddled with costly functional replication'. According to the author, administering authorities' claims that their fund's local identity is important is 'self-serving nonsense' and 'meaningless to the membership.'

5.10 The report goes on to speculate that the current asset pooling proposals, following the November 2015 Government consultation, will not be enough given the little material impact any cost-savings achieved will have on the sustainability of the Scheme, and calls for a dramatic simplification of the LGPS whereby local architecture is 'swept away' to leave just asset pools and specialist investment vehicles, each with an independent governance committee. The author proposes that DCLG puts the proposed LGPS asset pools 'on notice', that they will be in a performance-based competition for the five years from their 'go-live dates, after which they will be whittled down to three much larger pools.

5.11 Following on from recent CPS papers entitled “The LGPS: Unsustainable” and “LGPS 2018” the author concludes the report with the same underlying proposal that, ultimately, the Government should look to use the LGPS’s assets to seed an infrastructure-focused sovereign wealth fund that will allow the whole of society to benefit from its infrastructure based assets, namely airports, rail and road improvements.

Industry response

5.12 The CPS report “The LGPS: A Lost Decade” has been met with a fairly muted response within the pensions industry. This is in stark contrast to the response to the recent CPS papers, “The LGPS: Unsustainable” and “LGPS 2018” which were received negatively by the industry and generated numerous articles and commentaries by experts dispelling the ‘myths’ reported in the report.

5.13 In fact, the only response at the time of writing this report was an article published in CIPFA Public Finance on 2 February 2017 headed “Birmingham Council Leader brands LGS investment fees ‘a national disgrace’” in which John Clancy, leader of Birmingham City Council, backed the call by CPS for LGPS funds to move from active investment to passive investing. Mr Clancy was quoted as saying:

“The Centre for Policy Studies report is a vindication of what I have been saying for a long time – local government pension schemes across the country and here in the West Midlands are a dysfunctional mess and not fit for purpose.

There is no need to hire investment managers at all. But the brutal truth is that funds up and down the country have happily spewed out hundreds of millions of pounds to City advisers for no real return whatsoever.

This is a national disgrace, which is sucking money from local authorities at a time when public services are under threat as never before. If investment managers do not add value to a fund, they should not be paid.”

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6. Formal measurement of the performance of the investment adviser

Purpose of the report

The purpose of this report is to inform Panel members of the requirement to formally assess the performance of the Pension Fund Panel investment adviser, and to enclose a "scorecard" for use in this process for the year to 31 March 2017.

Recommendation

The Panel is requested to accept the report.

Key issues

6.1 The CIPFA guidance on decision making in the LGPS effectively recommends that pension committees should formally assess the performance of the investment adviser periodically.

6.2 The fifth such formal assessment of Mercer (the Fund's investment adviser) took place a year ago, using a "scorecard" approach. Annual assessment is appropriate, and therefore the formal assessment for the work undertaken by Mercer in the year to 31 March 2017 is now due.

6.3 A scorecard, in the same format as last year's is **enclosed with these papers** (**Enclosure 1**). Each Panel member and observer is asked to complete the scorecard enclosed with the Panel papers and return it to Craig Johnson before 7 April 2017. Page 1 of the scorecard lists the work undertaken by Mercer on the Fund's behalf during 2016/2017.

6.4 The completed scorecards will be summarised and reported to the June 2017 meeting, and feedback given to the adviser.

6. Formal measurement of the performance of the investment adviser

BACKGROUND

CIPFA guidance on the formal assessment of the adviser

6.5 CIPFA (The Chartered Institute of Public Finance and Accountancy) issued a publication on 11 December 2009 called *Investment Decision-Making in the Local Government Pension Scheme: A Guide to the Application of the Myners Principles*.

6.6 **Principle 4** shown on **page 19** of CIPFA's investment decision-making guidance says:

Arrangements should be in place for the formal measurement of the performance of the investments, investment managers and advisers. Administering authorities should also periodically make a formal policy assessment of their own effectiveness as a decision-making body and report on this to scheme members.

Formal process followed

6.7 At the February 2011 Pension Fund Panel meeting, a formal process was agreed, using a "scorecard" approach similar to the standard version prepared by Pensions and Lifetime Savings Association (then called National Association of Pension Funds), amended to suit Northumberland County Council Pension Fund's requirements.

6.8 Given that the relationship with the adviser is expected to be for the medium to long-term, it was agreed that assessment should be carried out no more frequently than annually.

6.9 Each Panel member is asked to complete a scorecard to cover the work undertaken by the adviser during the twelve months to 31 March of the year assessed, and the results are collated by officers and reported to the next Panel meeting. Feedback of the Panel's views is also given to the adviser. Panel members **can complete the scorecard anonymously**.

Formal assessment for work undertaken in the year to 31 March 2017

6.10 The investment adviser, Mercer, was selected and appointed by the Panel in March 2009, so has now been in place for eight years, during which time the adviser has undertaken significant projects on the Fund's behalf, such as the strategy and manager reviews. The adviser also provides on-going monitoring of the incumbent fund managers, which is an important risk control for the Fund.

6.11 The specific adviser assigned to the Northumberland County Council account during 2016/2017 was Joanne Holden, with Iain Campbell as support. Katrina Arbuckle was the "alternate" standing in when Joanne was unavailable to attend a meeting.

6.12 A scorecard, in the same format as last year's, has been **enclosed with these papers**, i.e. **Enclosure 1**. Panel members and observers are asked to complete the scorecards and return them to Craig Johnson before 7 April 2017.

6.13 As an aide memoire the scorecard shows, on **page 1**, the range of work undertaken by Mercer on the Fund's behalf during 2016/2017.

6.14 The completed scorecards will be summarised and reported to the June 2017 meeting, and feedback given to the adviser.

MEETING OF THE PENSION FUND PANEL

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7. Formal assessment of the effectiveness of the Pension Fund Panel

Purpose of the report

The purpose of this report is to inform Panel members of the requirement to formally assess the effectiveness of the Pension Fund Panel as a decision making body, and to seek approval for the drafted formal assessment attached to this report.

Recommendation

> **The Panel is requested to approve the formal assessment of the Pension Fund Panel as a decision making body, as set out in Appendix 6.**

Key issues

7.1 The CIPFA guidance on decision making in the LGPS effectively recommends that a pension committee should assess its own effectiveness as a decision-making body, periodically, and report on this to Scheme members.

7.2 Annual assessment is appropriate, and the formal assessment for the work undertaken by the Panel in the year to 31 March 2017 is now due.

7.3 The significant work undertaken by the Panel in 2016/2017 includes:

- active participation in the development and establishment of the Border to Coast Pensions Partnership (BCPP) pooling arrangement;
- approval of NCC Pension Fund's first Investment Strategy Statement;
- transition of M&G's active global equity portfolio to Legal and General, the Fund's passive manager, in four tranches;
- consideration of Mercer's initial strategy review in October 2016, to be completed in March 2017;
- consideration of currency hedging on the Fund's overseas equity exposure;
- review of the funding strategy and assumptions used in the Fund's 31 March 2016 actuarial valuation and review of covenant risk of the employers;
- development of the breaches log for pensions administration; and
- consideration of shared services with Tyne and Wear Pension Fund.

The NCC LGPS Local Pension Board and the Panel have worked together to maximise the benefit to the Fund of the current governance arrangements.

7.4 A formal <u>assessment</u> of decisions made (to date) has been drafted and attached as **Appendix 6** to this report. Members are asked to consider this assessment and make suggestions for changes if appropriate. The approach taken when drafting the assessment was to consider the 'controls' in place to help prevent poor decisions being made. The formal assessment will be included in the Pension Fund annual report and accounts for 2016/2017.

7. Formal assessment of the effectiveness of the Pension Fund Panel

BACKGROUND

CIPFA guidance

7.5 CIPFA (The Chartered Institute of Public Finance and Accountancy) issued a publication on 11 December 2009 called *Investment Decision-Making in the Local Government Pension Scheme: A Guide to the Application of the Myners Principles*.

7.6 **Principle 4** shown on **page 19** of CIPFA's investment decision-making guidance says:

Arrangements should be in place for the formal measurement of the performance of the investments, investment managers and advisers. Administering authorities should also periodically make a formal policy assessment of their own effectiveness as a decision-making body *and report on this to scheme members.*

7.7 This guidance goes on to suggest issues to consider for decision-making bodies such as the Pension Fund Panel:

The process of self-assessment involves both officers and members of the committee reviewing a range of items, including manager selection, asset allocation decisions, benchmarking decisions, employment of consultants and best value outcomes.

The objective of the reviews would be to consider whether outcomes were as anticipated, were appropriate, or could have been improved.

The committee should set out its expectations of its own performance in its business plan. This could include expected progress on certain matters, reviews of governance and performance and attendance targets. It should include standards relating to the administration of the committee's business such as:

- *attainment of standards set down in CIPFA's knowledge and skills framework*
- *achievement of required training outcomes*
- *achievement of administrative targets such as target dates for issuing agendas and minutes.*

This assessment should be included in the fund's annual report to its stakeholders.

Formal assessment of the effectiveness of the Panel - process

7.8 The first step in assessing the decisions made was to consider the backdrop of events and changes in the year in which those decisions were made. This was the approach taken when the first formal assessment took place in February 2011 to assess the effectiveness of the Pension Fund Panel as a decision-making body, and it has been followed each year since then.

7.9 The current Panel Chairman and the majority of the Panel members were appointed after the May 2013 local elections and joined the Panel then, and therefore it is appropriate, for the 2016/2017 assessment, to consider the decisions made in the Council year 2013/2014, 2014/15, 2015/2016 and 2016/2017. A summary of the decisions made by the Pension Fund Panel is presented to full Council in May each year, in any event, but it cannot be completed and brought to this (February) meeting.

7.10 When considering the effectiveness of decisions made, members are asked to consider whether the outcomes of decisions were as anticipated, were appropriate, or could have been improved.

Judging decisions made

7.11 Attempting to assess decisions made, after the event, is beset by problems. For example, if a decision is taken to allocate assets to corporate bonds shortly before corporate bonds fall in value, with the benefit of hindsight this decision would be judged to have been poor. However the decision may have been made based on the best available evidence at the time, and if judged at the time it was made would have been judged as good.

7.12 Another problem is the timescale applied to judge success or failure of a decision. For example, an active manager selected by the Panel may outperform its index in the first year of appointment and the decision to appoint would be judged a success, but if it then goes on to underperform over a three year period, is the decision now judged to be a failure? If it then goes on to outperform over a five year period, is the decision then a success?

7.13 Given the fact that pension fund investment is for the long term, there are strong arguments in favour of only measuring the success or failure of a decision after a long period of time, such as ten years. The make-up of the decision-making body is likely to have changed in that time which means that the Panel would be judged on the decisions taken by a completely separate group of people.

7.14 Another problem for assessing decisions is that many of the decisions made by the Panel are not empirically or objectively measurable. For example, the decision to appoint the investment adviser cannot be measured objectively, as it is not possible to judge which of the decisions made subsequently by the Panel may have been made differently if another adviser had been selected instead.

7.15 The quality of the decisions made by the Panel with the input of the adviser depends greatly on the relationship, trust and understanding built up between the two, and this relationship can only be measured subjectively by the parties involved.

Assessing the effectiveness of the Panel

7.16 The guidance requires an assessment, and therefore a formal assessment has been drafted and attached as **Appendix 6** to this report. It has been purposefully kept short and succinct. Members are asked to consider this and make suggestions for changes if appropriate.

7.17 The approach taken when drafting the assessment was to consider the 'controls' in place to help prevent poor decisions being made. For example, one of the key 'controls' would be the presence of the adviser at each meeting to ensure that Panel decisions made comply with the LGPS and other regulations, coupled with the meetings being conducted in a manner to allow the adviser time and opportunity to give his/her advice.

7.18 The formal assessment considers the areas which help support the Panel in making effective decisions, such as the **continuity** of Panel membership. Continuity is recognised as being of vital importance as it takes time for Panel members to build up the knowledge and expertise necessary to feel confident in making decisions.

7.19 This assessment, once approved, should be reported to stakeholders; therefore it will be included in the Pension Fund annual report and accounts for 2016/2017 and published on the NCC website.

Matters considered in the year 2016/2017

7.20 The main substantive piece of work undertaken by the Panel in 2016/2017 was the active participation in the development and establishment of the Border to Coast Pensions Partnership (BCPP) pooling arrangement, including recommending to Cabinet and full Council that NCC Pension Fund should join BCPP Pool.

7.21 The list below is a reminder of some of the matters considered in 2016/2017:

- assets managed by M&G transferred to Legal and General;
- the Fund's first Investment Strategy Statement introduced;
- the Funding Strategy Statement reviewed and changed;
- the assumptions and methodology of the 31 March 2016 valuation reviewed;
- the breaches reporting log developed (for pensions administration);
- currency hedging considered;
- shared services with Tyne and Wear Pension Fund considered;
- GMP reconciliation requirements considered;
- Pension Fund accounts and external audit results considered;
- quarterly fund manager performance reviewed; and
- the Fund's 2016/2017 strategy review started.

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8. Forthcoming training for Pension Fund Panel members

Purpose of the report

The purpose of this report is to provide information about a forthcoming training event for Panel members.

Recommendation

The Panel is requested to nominate attendees, if appropriate, for the LGA conference in June 2017 in Bournemouth.

Key issues

LGA annual LGPS "trustees" conference

8.1 The Local Government Association (LGA) annual LGPS "trustees" conference is scheduled on **29** and **30 June 2017** in **Bournemouth**. This is the fourteenth annual trustees' conference run by LGA, and members/officers have attended the equivalent event in prior years and found it to be relevant, well run and excellent value for money. Information about the conference is attached as **Appendix 7** to this report, with the topics to be included shown on page 2 of Appendix 7. Panel members are asked to consider their availability for this conference.

8.2 As the May 2017 local elections in Northumberland will make it difficult to predict the Panel membership in June 2017, members could consider booking a number of places for officers, Panel and/or Board members, to be allocated to individuals after the Panel membership has been agreed, late in May 2017.

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9. Northumberland County Council Funding Strategy Statement

Purpose of the report

This report seeks approval for NCC's updated Funding Strategy Statement (FSS), dated March 2017.

Recommendation

The Panel is requested to:

(i) approve the NCC Funding Strategy Statement attached as Appendix 8 to this report; and

(ii) delegate authority to the Chief Executive in consultation with the Chairman and Vice Chairman of the Panel to make any further changes required to the Statement as a result of the consultation with the participating employers, DfE and trade unions.

Key issues

9.1 In compliance with the LGPS Regulations, Northumberland County Council has had a Funding Strategy Statement (FSS) in place since the 2004 actuarial valuation of the LGPS Pension Fund. The FSS has been changed and updated since then on (at least) a **triennial** basis, to tie in with the triennial actuarial valuation cycle,

9.2 Regulation 58 of the 2013 LGPS Regulations introduced the requirement to review the FSS before 31 March 2015, which, in effect, brought in a requirement for an additional, one-off review. Therefore, the last update was as at 31 March 2015. in order to complete the 31 March 2016 actuarial valuation of the Fund, NCC's FSS must be updated <u>before 31 March 2017</u> when the 31 March 2016 actuarial valuation will be finalised.

9.3 The changes made to the 2017 NCC FSS are:

- to introduce a maximum of 21 year deficit recovery period for all employers (with one specified exception); and
- to update the references to LGPS Regulations and CIPFA guidance contained within it.

The participating employers, DfE and relevant trade unions will be consulted on the 2017 FSS in early March 2017.

Delegated authority to finalise the FSS, after consultation, is sought from the Panel at this meeting, to ensure the 2017 NCC FSS is in place before the 31 March 2016 actuarial valuation of the Fund is finalised.

9. Northumberland County Council Funding Strategy Statement

BACKGROUND

Impact of the Funding Strategy Statement (FSS)

9.4 The new regulatory requirement for all LGPS funds to have a Funding Strategy Statement (FSS) in place was introduced **prior to the 2004 valuation** being finalised.

9.5 The main effect of the FSS, as far as most of the participating employers were concerned, was to set the **recovery period** for the payment of their share of the Fund's deficit. Prior to this, the actuary used the average future working life of the contributors, i.e. usually around ten to thirteen years, as the deficit amortisation (or recovery) period.

9.6 Introducing the FSS allowed employers to extend the deficit recovery periods, and thereby mitigate the immediate impact of increasing contributions. Without it, employer contribution rates would have gone up significantly more than they did in 2005/2006. The existence of the FSS enabled the actuary to phase in the increases at that time more smoothly than would have been possible without it.

9.7 The requirement for each fund to have a FSS in place was introduced by Government to help local authorities manage their budgets. At that time, the view was that deficits were at an all-time high, and it would be better to allow local government to adopt policies which were, in effect, "pay less now, pay more later, if necessary".

9.8 The LGPS Regulations require the actuary to *take the provisions of the FSS into account* in the triennial actuarial valuation. The FSS must be **revised at least every three years**, and consulted upon if material change is made.

The 2014 NCC FSS

9.9 The Northumberland County Council FSS was last *fully* revised early in 2014, to tie in with the triennial actuarial valuation cycle and to ensure consistency with the assumptions used by the actuary at the 31 March 2013 actuarial valuation.

9.10 NCC's 2004 FSS (i.e. the original) allowed employers to adopt a deficit amortisation period of up to **30 years**, with a recommendation that employers adopt an amortisation period of no more than **25 years**. The only exception to this was for employers whose Scheme participation was based on a short term contract, in which case the recovery period matched the term of the contract. The majority of employers opted for a 25 year spread and continued with the same amortisation period at the 2007 and 2010 valuations. Long recovery periods were viewed as a temporary measure, with the expectation that they would be reduced at each subsequent actuarial valuation, until they returned to a period equivalent to the average future working lifetime of the active members.

9.11 Since the 2004 valuation, in general LGPS deficits have not reduced. Prior to the 2013 valuation, NCC had not found the opportunity to reduce the deficit recovery period used but the majority of other LGPS funds *had* reduced it, with around 20 years being the norm. Therefore, reducing the deficit recovery period in the NCC Pension Fund was a key change introduced in 2014.

9.12 The changes made to the 2014 NCC FSS at that point were:

- to introduce a maximum of 22 year deficit recovery period for all employers (with one specified exception);
- to update the references to LGPS Regulations and CIPFA guidance contained within it;
- to clarify that small scheduled employers (resolution bodies) will be pooled together as a group; and
- to provide that cessation valuations for academies will be calculated on an orphan basis, irrespective of whether the subsumption basis or orphan funding target has been used for on-going contributions.

Employers were consulted in February/March 2014 before finalising the 2014 FSS.

FSS update required by the Local Government Pension Scheme Regulations 2013

9.13 The LGPS Regulations 2013 (SI 2013 No. 2356, made 12 September 2013) which came into effect on 1 April 2014, contain the following requirements in relation to FSSs:

"**Funding strategy statement**
58.
(1) An administering authority must, after consultation with such persons as it considers appropriate, prepare, maintain and publish a written statement setting out its funding strategy.

(2) The statement must be published no later than 31st March 2015.

(3) The authority must keep the statement under review and, after consultation with such persons as it considers appropriate, make such revisions as are appropriate following a material change in its policy set out in the statement, and if revisions are made, publish the statement as revised.

(4) In preparing, maintaining and reviewing the statement, the administering authority must have regard to—

(a) the guidance set out in the document published in March 2004 by CIPFA, the Chartered Institute of Public Finance and Accountancy and called "CIPFA Pensions Panel Guidance on Preparing and Maintaining a Funding Strategy Statement (Guidance note issue No. 6)" and
(b) the statement of investment principles published by the administering authority under regulation 12 of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009"

9.14 Regulation 58, therefore, effectively introduced the requirement to review the FSS before 31 March 2015 as an additional, one-off review.

9.15 **Minor** changes to the 2014 version were made:
- to update the references to LGPS Regulations contained within it; and
- to change some terminology used to reflect new terminology in the Regulations.

As these changes were not material, no further consultation on the 2015 FSS was carried out.

<u>The 2017 NCC FSS</u>

9.16 The NCC Funding Strategy Statement has been updated and attached as **Appendix 8** to this report.

9.17 The current (revised) version of the CIPFA guidance, referred to in Regulation 58(4), is **enclosed** with these papers. CIPFA's 2016 edition of the guidance "*preparing and maintaining a Funding Strategy Statement in the LGPS"* replaces the 2004 version referred to in the Regulations and the previous version, issued in 2012.

9.18 The changes made to the 2017 NCC FSS are:
- to introduce a maximum of 21 year deficit recovery period for all employers (with one specified exception); and
- to update the references to LGPS Regulations and CIPFA guidance contained within it, including:
  - "*common contribution rate*" has been replaced by "*primary contribution rate*";
  - "*Statement of Investment Principles*" has been replaced by "*Investment Strategy Statement*";
  - "*ensures that the regulatory requirements to set contributions so as to ensure the solvency and long-term cost efficiency of the Fund are met*" and "*take measures as set out in the 2013 Regulations to safeguard the Fund against the consequences of employer default"* are now added;
  - "*smoothing the contributions*" has been removed, and the FSS now only refers to primary rates (i.e. the future service rates) being kept as stable as possible; and
  - "*notional sub-funds*" has been replaced by "*notional asset shares*".

9.19 The Regulations (and CIPFA guidance) require consultation on the FSS with such persons as the administering authority considers appropriate, and therefore, once approved by the Panel at this meeting, the participating employers, DfE and relevant trade unions will be consulted on the 2017 FSS.

9.20 Delegated authority to finalise the FSS, after consultation, is sought from the Panel at this meeting, to ensure the 2017 NCC FSS is in place before the 31 March 2016 actuarial valuation is finalised.

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REPORT OF THE CHIEF EXECUTIVE

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10. AAF 01/06 reports on internal controls operated by fund managers and the custodian

Purpose of the Report

The purpose of this report is to provide information to the Panel about the most recently available AAF 01/06 (or equivalent) reports provided by Northumberland County Council Pension Fund's custodian and its investment managers.

Recommendation

The Panel is requested to accept the report.

Key issues

10.1 AAF 01/06 reports (or equivalent) are prepared at least annually by the Fund's custodian and fund managers, to describe the internal controls each has in place to protect the interests of clients.

10.2 AAF 01/06 is a framework, produced in 2006 by the Audit and Assurance Faculty of the Institute of Chartered Accountants in England and Wales, working with other stakeholders such as the National Association of Pension Funds, to provide guidance to fund managers and custodians on reporting internal controls to clients. The "assurance reports on internal controls of service organisations made available for third parties" provided to clients by the service providers are independently verified by an accountant who tests the internal controls described in the reports.

10.3 The purpose of the AAF 01/06 report is to provide comfort to clients and their auditors on the security of assets held by custodians and managed by fund managers. It is produced on a voluntary basis, and all of Northumberland County Council Pension Fund's managers and custodian have provided a report or a suitable substitute.

10.4 The most up to date reports available have been obtained and reviewed by officers. In all of them the reporting accountants noted no significant control weakness.

10.5 The Fund's external auditors (EY) review the most recent AAF 01/06 reports as part of their year-end audit work, as well as the Pension Fund Panel meeting minutes, which show that the control assurance reports have been reported (annually) to the Panel.

10. AAF 01/06 reports on internal controls operated by fund managers and the custodian

BACKGROUND

10.6 AAF 01/06 reports and SSAE16 reports (i.e. the US equivalent of AAF 01/06) are obtained by the Pensions Accounting Team from the fund managers and custodian, normally on an annual basis, though sometimes more frequently. AAF 01/06 report means a report prepared by the fund manager, or custodian, describing the control environment and control objectives for UK managed clients, and the policies and procedures established to meet these objectives. It is produced for third parties (i.e. clients) to provide assurance on the control environment operated by the service provider. The report also contains the opinion of the reporting accountant who has tested the internal controls described in the report. AAF 01/06 replaced the previous guidance for reporting accountants contained in FRAG 21. SSAE16 stands for Standards of Attestation Engagements number 16, and this replaces SAS 70 reports.

10.7 The AAF 01/06 report is intended to provide comfort to clients and their auditors regarding the security of assets held by custodians and managed by fund managers, in a consistent reporting standard. An AAF 01/06 internal controls report is one produced under the guidance issued by the **Audit and Assurance Faculty** of the Institute of Chartered Accountants in England and Wales. This guidance is for both directors and reporting accountants and recommends that the report covers certain key controls. The AAF 01/06 report is the responsibility of the directors of the entity reported on.

10.8 There is no legal obligation on fund managers or custodians to provide an AAF 01/06 report, however, all of the managers that manage the Northumberland Fund and the Fund’s custodian have provided one, or a suitable substitute.

10.9 Prior to preparing this report, officers requested the most recent AAF 01/06 reports or equivalent from the Fund’s custodian, its managers and each managers’ own custodian. AAF 01/06 (or equivalent) reports received are as follows:

- Assurance Report on Internal Controls for the year ended 31 December 2015 for **Legal & General** Investment Management (Holdings) Limited, plus PMC Custody of Assets Briefing Note (not a control report), providing a position statement as at April 2015, relating to Legal & General’s custodian;

- Internal Controls Report for the year ended 31 December 2015, for **Schroder** Investment Management Limited;

- Report on Internal Controls for the year ended 30 September 2016 for **BlackRock**;

- Report on the Suitability of the Design of Controls as of 30 September 2016, for **Morgan Stanley**;

- Internal Controls of the Investment Management Activities for the year ended 31 December 2015 for **M&G** Investments, plus HSBC SAS70 Report for the eleven months to 30 November 2015, relating to M&G's custodian;

- Internal Controls of the Investment Management Activities for the year ended 31 December 2015 for **NB Alternatives** Investments;

- Internal Controls of the Investment Management Activities for the year ended 31 October 2015 for **Wellington**;

- Internal Controls of the Investment Management Activities for the six months to 31 December 2015 for **Antin**;

- Custody and Fund Services – Service Organisation Control Report for the year ended 30 September 2016 for **Northern Trust**.

10.10 **GIP** does not have an AAF 01/06 or equivalent report, but has sent a report from its custodian, J.P. Morgan, on the Suitability of the Design and Operating Effectiveness of its Controls, referring to its internal controls for the six months to 30 September 2016.

10.11 For each of the reports listed above, the reporting accountants noted no significant control weakness.

10.12 Copies of the AAF 01/06 reports are held by the Pensions Accounting Team, and can be made available upon request.

<u>Mercer's manager research</u>

10.13 The Fund obtained Mercer's Operations and Implementation Risk reports, prepared in March 2011 regarding BlackRock, and in February 2011 regarding Legal & General.

10.14 Mercer conducts ongoing research and monitoring of the Fund's managers, and flags with clients where it has any concerns. The information within Mercer's Operations reports is fed into the overall research notes and manager ratings which Mercer provides to NCC in the quarterly monitoring report.

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11. Key Performance Indicators (KPIs) for the Pensions Administration Team

Purpose of the report

The purpose of this report is to provide information to the Panel about the KPIs in the quarter to 31 December 2016.

Recommendation

The Panel is requested to accept the report.

Key issues

11.1 The NCC Pension Fund's Administration Strategy Statement was updated and approved at the November 2016 Panel meeting. The Statement refers to Key Performance Indicators (KPIs) for the Pensions Administration Team. These KPIs will be reported to the Panel on a quarterly basis from now on. **Appendix 9** sets out the KPIs in full.

11.2 KPIs achieved in the quarter to 31 December 2016:

Process	Fund timescale	Target	Quarter to 31 December 2016
To process new member information	**30 days of receiving all information**	**95%**	**45% ***
To inform members who leave of their rights and options available	**30 days from date of receiving information**	**90%**	**72%**
To notify the amount of benefits payable on retirement	**5 days of receipt of all necessary information**	**95%**	**72%**
To notify dependant(s) of the amount of death benefits	**5 days of receipt of all necessary information**	**95%**	**79%**
Provide annual benefit statements	**31 August in the same calendar year**	**100%**	**N/A †**
Receipt of employee contributions from employers	**19th of the month following deduction**	**100%**	**100%**
Receipt of employer contributions	**19th of the month**	**100%**	**100%**

* An exceptionally high volume of new members starting in September 2016 resulted in this KPI not being met.

† ABSs are only due in the quarter to 30 September.

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12. Fund performance and total Fund value

Purpose of the report

The purpose of this report is to provide information to the Panel about the Fund performance in the quarter to 30 September 2016 and the total Fund value at that date.

Recommendation

The Panel is requested to accept the report.

Key issues

12.1 The total Fund value (externally managed) was **£1,264** million as at 31 December 2016, compared to £1,224 million as at 30 September 2016, reflecting the positive investment returns over the quarter.

12.2 The Fund returned **3.2%** in the quarter to 31 December 2016.

12.3 This has been a good quarter for the Fund except for the BlackRock Property fund that underperformed. Both of Wellington's funds, GTR and MSC, the Schroder Property fund and M&G have outperformed in the quarter.

12. Fund performance and total Fund value

BACKGROUND

Total Fund value

12.4 The total value of the Fund at the last four quarter ends is as follows:

	as at 31 March 2016 £m	as at 30 June 2016 £m	as at 30 September 2016 £m	as at 30 December 2016 £m
Legal & General *Index tracker*	**710.65**	**766.27**	**908.77**	**1008.96**
M&G Investments *Active global equities*	**116.92**	**124.51**	**71.38**	**0.0**
Wellington *Active corporate bonds*	**93.61**	**95.53**	**97.76**	**98.30**
Schroder	25.73	25.89	25.16	25.94
BlackRock	25.08	25.34	24.57	24.27
Property **subtotal**	**50.81**	**51.23**	**49.73**	**50.21**
Morgan Stanley	40.72	38.06	34.60	35.67
NB Crossroads	16.67	17.64	19.53	21.09
Private equity **subtotal**	**57.39**	**55.70**	**54.13**	**56.76**
GIP	18.42	23.94	26.89	31.07
Antin	13.00	14.73	15.43	18.34
Infrastructure **subtotal**	**31.42**	**38.67**	**42.32**	**49.41**
Total	**1,060.80**	**1,131.91**	**1,224.09**	**1,263.64**

Note that capital calls and/or capital repayments have been made during the year to 31 December 2016 for private equity and infrastructure funds. Extra funding, when needed, came out of cash held by the Pension Fund for the day-to-day expenditure incurred in administering the Scheme and by disinvesting from Legal & General. Capital repayments have been transferred to Legal & General to invest, or when timing can be matched, used to pay other capital calls.

12.5 Further details of Fund performance is provided in the Mercer's enclosure.

Fund performance

12.6 The Fund's performance is measured by the GS Performance Services (formerly the WM Company). Shown below are the annual returns achieved by the Fund for the five years to 31 March 2016 and for the latest four quarters. Also shown are the annualised returns achieved by the Fund for the five years to 31 March 2016.

12.7 Annual returns

	Financial Year Ended 31 March				
	2012	2013	2014	2015	2016
	%	%	%	%	%
Fund	5.3	14.0	3.8	13.2	-0.7
Benchmark	4.8	14.2	3.7	13.1	-1.2

12.8 Quarterly returns

	- - 2015/16 - -	- - - 2016/17 - - -		
	Quarter 4 to 31 Mar 16	Quarter 1 to 30 Jun 16	Quarter 2 to 30 Sep 16	Quarter 3 to 30 Dec 16
	%	%	%	%
Fund	2.4	6.7	9.4	3.2
Benchmark	2.7	N/A	N/A	N/A
Relative return	-0.3	N/A	N/A	N/A

12.9 Annualised returns

	All Financial Years Ended 31 March		
	2011/16	2013/16	2016
	%	%	%
Fund	7.1	5.4	-0.7
Benchmark	6.6	5.1	-0.2
	5 years	3 years	1 year

IMPLICATIONS ARISING OUT OF THE REPORT

This applies to items 1. to 12. (inclusive) in this report

Policy:	Report 1 seeks approval for the Fund's Investment Strategy Statement, report 2 seeks endorsement of Legal and General's Corporate Governance and Responsible Investment Policy, and report 9 seeks approval for NCC's Funding Strategy Statement. None of the other reports have policy implications.
Finance and value for money:	All investment decisions and funding strategy decisions could have an implication for the future employer contribution rates payable by employers participating in the Pension Fund. There are no investment decisions arising directly from these reports.
Human Resources:	None
Property:	None
Equalities:	None
Risk Assessment:	A risk assessment is performed as part of the asset liability modelling study undertaken periodically (usually every three years) to set the Fund's asset allocation strategy. There is no change to investment strategy contained within these reports.
Sustainability:	None
Crime & Disorder:	None
Customer considerations:	None
Consultation:	None
Electoral divisions:	All

Report sign off

Finance Officer	N/A
Monitoring Officer/Legal	N/A
Human Resources	N/A
Procurement	N/A
I.T.	N/A
Executive Director (Chief Executive)	SM
Portfolio Holder(s)	N/A

Report author Clare Gorman
01670 623579
clare.gorman@northumberland.gov.uk