Agenda

AGENDA for a meeting of the PENSIONS COMMITTEE to be held in COMMITTEE ROOM B, County Hall, Hertford on WEDNESDAY, 28 FEBRUARY 2018 at 10:00AM

MEMBERS OF THE COMMITTEE (10) - QUORUM 3

S J Boulton, D S Drury, J M Graham, C M Hayward, J G L King, A J S Mitchell, R G Parker, S Quilty, R Sangster, J D Williams (Chairman)

REPRESENTATIVES OF HERTFORDSHIRE DISTRICT / BOROUGH COUNCILS (3) (NON-VOTING)

J Lloyd, K Ayling, M Freeman

Invitees:

Isabel Brittain, District Finance Representative

Meetings of the Committee are open to the public (this includes the press) and attendance is welcomed. However, there may be occasions when the public are excluded from the meeting for particular items of business. Any such items would be taken at the end of the public part of the meeting and listed under “Part Two (‘closed’) agenda”.

Committee Room B is fitted with an audio system to assist those with hearing impairment. Anyone who wishes to use this should contact main (front) reception.

Members are reminded that all equalities implications and equalities impact assessments undertaken in relation to any matter on this agenda must be rigorously considered prior to any decision being reached on that matter.

Members are reminded that:

(1) if they consider that they have a Disclosable Pecuniary Interest in any matter to be considered at the meeting they must declare that interest and must not participate in or vote on that matter unless a dispensation has been granted by the Standards Committee;

(2) if they consider that they have a Declarable Interest (as defined in paragraph 5.3 of the Code of Conduct for Members) in any matter to be considered at the meeting they must declare the existence and nature of that interest. If a member has a Declarable Interest they should consider whether they should participate in consideration of the matter and vote on it.

PART I (PUBLIC) AGENDA

1. MINUTES

To confirm the minutes (Parts I and II) of the Pensions Committee meeting held on 29 November 2017.

2. GENERAL DATA PROTECTION REGULATIONS (GDPR)

Report of the Local Pensions Partnership

3. PENSIONS COMMITTEE BUSINESS PLAN FOR 2018-19

Report of the Director of Resources

4. RISK AND PERFORMANCE

Report of the Director of Resources

5. ACCOUNTING ISSUE - EMPLOYER JULY & AUGUST 2017 FRS102 REPORTS

Report of the Director of Resources

6. 2018/19 TREASURY MANAGEMENT STRATEGY FOR PENSION FUND

Report of the Director of Resources

7. INTRODUCTION TO SECURITIES LENDING

Report of Mercer

PART II ('CLOSED') AGENDA

EXCLUSION OF PRESS AND PUBLIC

The Chairman will move:-

"That under Section 100(A)(4) of the Local Government Act 1972, the press and public be excluded from the meeting for the following item of business on the grounds that it involves the likely disclosure of exempt information as defined in paragraph 3 of Part 1 of Schedule 12A to the said Act and the public interest in maintaining the exemption outweighs the public interest in disclosing the information."

PART II ('CLOSED') AGENDA

1. **ACCESS UPDATE**

   Report of the Director of Resources

2. **PENSION FUND – FUNDING AND INVESTMENT REPORT (Formerly PERFORMANCE REPORT) AS AT 31 DECEMBER 2017**

   Report of the Director of Resources

3. **REAL ASSET PORTFOLIO NEXT STEPS - INFRASTRUCTURE DEBT MANAGER SELECTION**

   Report of Mercer

If you require further information about this agenda please contact Stephanie Tarrant, Democratic Services Officer, on telephone no (01992) 555481 or e-mail Stephanie.tarrant@hertfordshire.gov.uk

Agenda documents are also available on the internet at:
https://cmis.hertfordshire.gov.uk/hertfordshire/Calendarofcouncilmeetings.aspx

For further information about the issues covered in these reports please contact Patrick Towey on 01992 555148.

KATHRYN PETTITT
CHIEF LEGAL OFFICER

Minutes

To: All Members of the Pensions Committee

From: Legal, Democratic & Statutory Services
Ask for: Stephanie Tarrant
Ext: 25481

PENSIONS COMMITTEE
29 NOVEMBER 2017

ATTENDANCE

MEMBERS OF THE PENSIONS COMMITEE

S J Boulton, Morris Bright (substituted for C M Hayward), D S Drury, J S Kaye (substituted for J M Graham), J G L King, A J S Mitchell, R G Parker, S Quilty, R Sangster, J D Williams (Chairman)

MEMBERS OF HERTFORDSHIRE DISTRICT/BOROUGH COUNCILS (NON-VOTING)

M Freeman, K Ayling

Upon consideration of the agenda for the Pensions Committee meeting on 29 November 2017 as circulated, copy annexed, conclusions were reached and are recorded below:

Note: No conflicts of interest were declared by any member of the Committee in relation to the matters on which conclusions were reached at this meeting.

PART I ('OPEN') BUSINESS

ACTION

1. MINUTES

1.1 Minutes (Part I and II) of the meeting of the Pensions Committee held on 31 October 2017 were confirmed as a correct record and signed by the Chairman.

2. RISK AND PERFORMANCE
[Officer Contact: Jolyon Adam, Finance Manager, Telephone: 01992 555078]

2.1 The Committee reviewed a report which detailed the quarterly update on Risk and Performance for the Pension Fund for the period 1 July to 30 September 2017.

2.2 Members noted the updates in the risk register (section 4 of the report) and were informed that the funding level noted at risk B was incorrect. It was advised that instead of the fund being 99% funded with a £46 million deficit, the fund was 97% funded with a £151 million deficit.

2.3 Members noted that the Pensions Board received and monitored details of employer late payments in the Local Pensions Partnership's (LPP's) quarterly administration report. It was also noted that the LPP were down on service level agreement performance at Quarter 2, however it was advised that a new operating model within the LPP meant that additional support will be provided by other LPP sites during periods of additional work pressure and increased transaction volumes.

2.4 Members noted the update on the Scheme of Employers Risk Monitoring alongside appendix A, which set out an action plan for outstanding admission agreements. In response to a Member question it was clarified that a risk category of 1 year +, meant that it had been over a year since the commencement of the employers service contract. It was noted that the Fund was obliged to admit employers to the scheme despite the time lapse as they were usually employees who had been TUPE transferred and therefore entitled to remain part of the LGPS fund. Members heard that the delay in admission agreements was not Hertfordshire specific and that funds across the Country experienced similar problems. Members discussed the options available to begin charging a penalty rate which would help address the backlog.

2.5 Members discussed the summary of outstanding admission agreements in Appendix A and looked at employer number 10 as an example. Officers explained that the way in which the actuary Hyman's calculated the contribution rate could result in an employer with a small number of mature employees and a small contract period having a high contribution rate. This could be mitigated if the ceding employer agreed to risk share and a lower contribution rate could be set instead. Officers are exploring alternative options with the scheme actuary with the view to developing a policy in the future.

2.6 In response to a Member question on where the responsibility fell if a TUPE employee was not yet admitted to the scheme by the new employer but entitled to benefits, it was advised that the ceding employer would need to make up any difference. It was noted that it was also in the ceding's employer's interest for the new admission agreement to be in place.

2.7 Members discussed why employers were not named in Appendix A and it was advised that there was an element of commercial sensitivity for some employers. It was however noted that the extent of detail provided for future reports would be reflected on.

CHAIRMAN'S INITIALS

……………..

Decision

2.8 The Pensions Committee noted the content of the report.

EXCLUSION OF PRESS AND PUBLIC

2.9 The Committee agreed to move into Part II ('closed' session').

2.10 That under Section 100(A)(4) of the Local Government Act 1972, the press and public be excluded from the meeting for the following items of business on the grounds that they involve the likely disclosure of exempt information as defined in paragraph 3 of Part 1 of Schedule 12A to the said Act and the public interest in maintaining the exemption outweighs the public interest in disclosing the information.

PART II ('CLOSED') AGENDA

1. PENSION FUND – FUNDING AND INVESTMENT REPORT (Formerly PERFORMANCE REPORT) AS AT 30 SEPTEMBER 2017

Decision

1.1 The Minute for this item of business is set out in the separate Part II Minutes.

2. REVIEW PAPER – JANUS HENDERSON INVESTORS

Decision

2.1 The Minute for this item of business is set out in the separate Part II Minutes.

3. INVESTMENT STRATEGY UPDATE

Decision

3.1 The Minute for this item of business is set out in the separate Part II Minutes.

4. ACCESS – OPERATOR PROCUREMENT

Decision

4.1 The Minute for this item of business is set out in the separate Part II Minutes.

5. ACCESS – PASSIVE PROCUREMENT AWARD

Decision

5.1 The Minute for this item of business is set out in the separate Part II Minutes.

6. PENSION FUND – COST OF INVESTMENT MANAGEMENT

Decision

6.1 The Minute for this item of business is set out in the separate Part II Minutes.

KATHRYN PETTITT
CHIEF LEGAL OFFICER **CHAIRMAN______________________**

HERTFORDSHIRE COUNTY COUNCIL

PENSIONS COMMITTEE
WEDNESDAY, 28 FEBRUARY 2018 AT 10:00AM

Agenda Item No.

2

GENERAL DATA PROTECTION REGULATIONS (GDPR)

Author: James Ahlberg, Information Governance Manager, Local Pensions Partnership

General Data Protection Regulations (GDPR)

Presented by James Ahlberg

Information Governance Manager

Local Pensions Partnership

What I will be covering…

- Background to the General Data Protection Regulation
- Why is it important?
- Key changes that will affect the LGPS
- First steps towards compliance
- Update on LPP's progress

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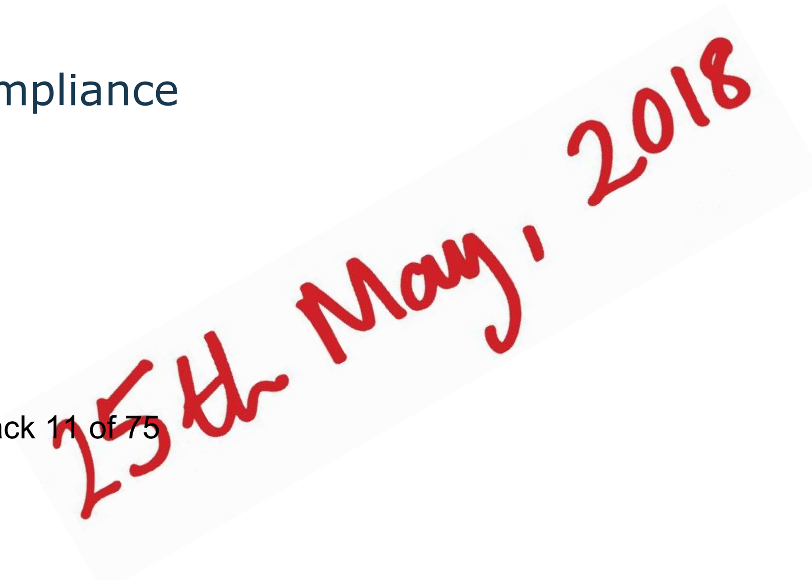
Background to General Data Protection Regulation (GDPR)

- What is it?
  - An EU regulation which will replace current EU Data Protection Directive 95/46/EC and the UK Data protection Act 1998
  - It provides a new legal framework setting out rules for processing personal data across the EU
  - Reinforces the existing law – Data Protection Act 1998 but:
    - Much more prescriptive
    - Higher penalties for non-compliance

- When does it come into force?
  - 25th of May 2018
  - Brexit to have little or no impact



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Why is it important?

Giant leap in penalties – up almost 4000%!

- Fines of up to greater of 4% annual worldwide turnover or €20 million for breaching key principles:
  - Data Security
  - Fair & Lawful processing
  - Transferring data outside the EU
  - Data subjects rights i.e. right of access, rectification, erasure

- Lower tier fines up to greater of 2% of annual worldwide turnover or €10 million for breaching lesser principles:
  - Failing to notify a data breach on time
  - Failing to have correct contract with service provider

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Why is it important?

Claims for compensation & other remedies

- Individuals can claim compensation for material and non-material damage i.e. Distress
- Not-for-profit bodies can bring representative actions on behalf of individuals
- New liability for data processors (pension administration service providers, IT providers etc) but data controllers (Administrating Authorities) remain primarily liable

- Additional wide powers:
  - Investigative i.e. demand information/ audits
  - Obtain access to premises, equipment etc
  - Warnings, temporary/ permanent bans on data use, order suspension of data flows

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Key changes that will affect the LGPS

Data Mapping/ Records of processing activities (article 30)

- Name and contact details of controller and DPO
- Purpose
- Categories of data and data subjects
- Categories of recipients
- Transfers to third countries, and documentation of safeguards
- Where possible, time limits to erasure
- Where possible, description of security measures
- Make available to Supervisory Authority on request

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Key changes that will affect the LGPS

Data Protection Officer (Article 37-39)

- Mandatory because a public authority
- Potentially could be one DPO for several authorities
- Basis of appointment
  - Professional qualities
  - Expert knowledge of data protection law
  - Ability to perform required services
- Must be actively involved in all issues relating to personal data
- Must report directly to most senior management

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Key changes that will affect the LGPS

Enhanced Privacy Notices – more information in a shorter notice!

- All existing privacy notices need to be revised to include new mandatory information (Articles 14 & 14a)
- Must be concise and intelligible, so more information but shorter text!
- Solutions:
  - Layering - Short summary of key/unusual data uses, plus link to fuller privacy notice
  - Just in time notices i.e. when sign up to a new service
  - Privacy dashboards – meaningful choices about data uses
  - Videos or animations
- Stricter limits on use/effectiveness of consents

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Key changes that will affect the LGPS

Privacy Impact assessments? (Article 33)

- Required where "high risk" to rights and freedoms of individuals, including:
  - Systematic and extensive evaluation based on automated processing, including profiling, that significantly affects individuals; or
  - Large scale processing of sensitive personal data

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Key changes that will affect the LGPS

Privacy by Design and Default

- Requires right level of data protection to be embedded in life cycle of applications, taking account of
  - available technology
  - cost
  - risks

- To include data minimisation and pseudonymisation

- Default settings must ensure that only the specific personal data needed for the purpose is processed i.e. amount of data, extent of processing, period of storage and accessibility.

- Increased importance of limiting amount of data collected and what is shared

Key changes that will affect the LGPS

Mandatory data breach notification – Robust data breach policy essential

- Must notify ICO of data breach unless unlikely to result in risk to individuals (i.e. some damage, or even loss of control of data)
- **Without undue delay** and where feasible within 72 hours after having become aware of the breach
  - Full details of the breach i.e. nature, categories and number of individuals affected, likely consequences and measures to address/mitigate the breach
- 72 hours = very short timescale – effective data breach handling procedure essential
- A *processor* shall notify the *controller* without undue delay
- A notification to the data subject **without undue delay** is also mandatory if breach likely to result in a high risk (not if encrypted so unintelligible)
- Controllers must document data breaches

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Key changes that will affect the LGPS

Service provider agreements – renegotiation & redrafting

- Expanded list of mandatory clauses to be included in every agreement that starts or continues after 25 May 2018
- For first time, direct obligations on processors, including
  - Security measures
  - Records of processing activities
  - Compliance on cross-border transfers
  - Co-operation with controller on compliance
- Big change in risk profile for processors
  - So likely to look to limit liability/seek indemnities

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Key changes that will affect the LGPS

And don't forget…

- Data Security – Will remain critically important
- Subject Access Requests – Will continue/increase in frequency
- Transfers Outside EEA – Will continue to need special terms/justifications
- Profiling/Automated Decision-making – Restrictions have been strengthened
- Right to be Forgotten - Expanded

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First Steps Towards Compliance

STEP 1 – Data Mapping & Gap Analysis

- Audit current position & identify major gaps in compliance
- Create/update records of personal data processed
- Develop & implement a compliance plan

STEP 2 – Data Privacy Officer

- Agree appropriate structure & roles for DPO(s)
- Develop job specification
- Recruit/appoint DPO(s)

STEP 3 - Data Protection Policies & Procedures

- Identify & review existing policies/procedures
- Update and add to these as required

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First Steps Towards Compliance

STEP 4 – Review data security & breach handling processes

- Review and update data security systems, processes & procedures
- Prepare and/or update data breach response plans

STEP 5 – Service Agreements

- Identify and prioritise existing agreements for review/renegotiation
- Revise standard templates to include new mandatory provisions

STEP 6 - Privacy Notices

- Update to insert mandatory content
- Consider layering notices

STEP 7 - Check you can 'demonstrate' compliance

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Update on LPP's progress

Step	LPP Progress
1	• High level & detailed gap analysis completed • Data mapping for admin business completed, other areas of the business ongoing
2	• DPO in place and a new Information Governance Manager appointed to head up GDPR implementation
3	• All policies and procedures identified and in the process of being updated
4	• A new process and system to report data breaches has been implemented • A detailed staff training plan for all staff is underway for roll out in March
5	• All service agreements have been identified and are in the process of being reviewed to ensure compliance by May 25th • Legal have drafted the supplemental agreement which is currently being reviewed
6	• LPP's Fair Processing Notice (FPN) is in draft format ready for review • Other privacy notices for the business are under review
7	• All decisions made are being recorded so LPP can demonstrate compliance to the ICO in case of audit or we have a data breach

Local Pensions Partnership

Any questions?

Source information for presentation gathered from Information Commissioners Office, Squires Patton Boggs & Dilys Jones Associates Ltd.

Local Pensions Partnership

HERTFORDSHIRE COUNTY COUNCIL

PENSIONS COMMITTEE
WEDNESDAY, 28 FEBRUARY 2018 AT 10:00AM

Agenda Item No:
3

PENSIONS COMMITTEE BUSINESS PLAN FOR 2018-19

Report of the Director of Resources

Author of the report: Patrick Towey, Head of Finance (Pensions and Treasury)
(Telephone: 01992 555148)

1. Purpose

1.1 The purpose of this report is to provide members of the Pension Committee a plan of agenda items that will come to this Committee for 2018/19. As a reminder for all members of the Pension Committee this report also provides a summary of a number of key policy and strategy documents which are kept under regular review by this Committee. In addition, this report also contains detail of the CIPFA knowledge and skills framework that has been developed for local Pension Boards. Officers will look to develop some of these knowledge areas with this Committee particularly through targeted training delivered by officers and external advisors.

2. Summary

2.1 The Hertfordshire County Council Pension Committee (PC) is responsible for the administration of both the Local Government Pension Scheme (LGPS) and the Fire Fighters Pension Scheme (FFPS). The Pension Committee has its delegation direct from full Council. The Committee's role with regards to both schemes is to set the Pension Fund Objectives and determine and maintain appropriate strategies, policies and procedures with ongoing monitoring of the Fund's activities.

2.2 From 1 April 2015, the Public Service Pensions Act 2013 introduced a further layer of governance in the form of Local Pension Boards. The role of the Boards is to assist the Administering Authority (Hertfordshire County Council) to secure compliance relating to governance and administration for both the LGPS and FFPS.

2.3 Attached as appendix A to this report is the business plan of work for the financial year 2018-19 that sets out some of the key activities that officers will be undertaking over this period and papers that will be brought before this Committee. Both the LGPS and FFPS Boards have separate work plans which will include the review of certain administration policies and proposing amendments for approval by the Pension Committee. The Pension Boards will also review decisions of the Pension Committee.

2.4 Allied to this work agenda it's essential that the knowledge of both the members of the PC and PB is developed so that they understand and can make/scrutinise decisions diligently, training will cover a number of areas to include but not limited to: investments, actuarial assessment, policy understanding, accounting, regulatory and legal, and communications. Training will be delivered to compliment certain pieces of work that both the PC and PB may be reviewing at a particular time in the pension cycle for example the actuarial valuation of the Fund or final accounts. This report sets out the annual business plan and proposed areas of training for this Pension Committee.

2.5 The Pension Committee meets six times per year; two of these informal meetings will be for the purpose of meeting some of the Fund's investment managers. Training will also be delivered as part of these Committee meetings.

2.6 Appendix B sets out in summary the CIPFA[1] knowledge and skills framework that has been developed for local pension boards. It's a requirement for members of pension boards to develop and acquire this knowledge and officers will develop and deliver training plans for both the LGPS and Fire Boards in conjunction with third party providers. Although not mandatory for elected members of the Pension Committee it's considered best practice for members to acquire knowledge in these areas in order that they can make informed decisions. Officers will look to develop training taking into consideration the working business on the Committee's agenda such as for example understanding of the pension Fund accounts when the Fund's accounts are presented for approval.

3. Recommendations

3.1 That the Committee notes the content of this report and comments on whether they wish to see any further items on the forward agenda.

4. Background

4.1 As Administering Authority for both the LGPS and the FFPS, the Council has delegated the responsibility for both schemes to the Pension Committee. As referred to in 2.2, the governance and administration of both schemes is supported by two local pension boards made up of equal employer and member representatives. The role of both these boards is to support and assist the PC in the delivery of its governance function and certain monitoring functions such as the oversight of the administration contract with the Local Pensions Partnership. In addition, both Boards will also review strategies and policies approved by the Pension Committee and may ask the Committee to review certain decisions.

4.2 The LGPS is a funded scheme in that contributions are made by both employers and members in the scheme; these contributions are invested through the Fund's investment managers with the key objective of ensuring that there are sufficient funds to meet the Fund's future liabilities. There are a number of policies and strategies that underpin the LGPS for which the

[1] CIPFA - Chartered Institute of Public Finance and Accountancy

Pension Committee has responsibility and a brief introduction to some of these key documents will be provided in this report.

4.3 Unlike the LGPS, the FFPS is an unfunded scheme in that members of the scheme make contributions through salary contributions and a top up grant is received from Central Government to meet any difference between income (member contributions) and expenditure (pension payments). The degree of oversight of the FFPS is reduced in that there is no investment strategy and fund manager performance monitoring to undertake and the main agenda items that will come before this Committee will be the approval of administering authority employer discretions and other member policies that are revised and need PC approval.

4.4 The working group of cross-party members that has been established in recent years to review the Fund's investment strategy and undertake reviews of asset allocations and de-risking will continue to play a key role in undertaking specific reviews of undertaking informative work for this Committee with the objective of proposing recommendations for this Committee's consideration and approval. Future work that will be undertaken in this area over the next twelve months will include the shortlisting of real asset managers for consideration and approval by this Committee.

4.5 Appendix A sets out the schedule of meetings for the Pension Committee and agenda items that will come to this Committee. The agenda will include papers that are business as usual items such as performance reporting, risk and governance, and asset pooling. Agendas may include additional items that need to be brought to this Committee's attention such as regulatory changes that may contain recommendations revising and updating current policies for approval. Both the FFPS and LGPS Boards will also have annual work plans and training to support their role in supporting this Committee.

4.6 CIPFA has set out a knowledge and skills framework for Pension Board members in order that those board members can undertake their role in assisting the Committee in the governance and effective management of the Hertfordshire Fund. Appendix B summarises the various modules of learning for board members.

4.7 Some of the knowledge requirements set out in appendix B have been delivered to members of this Pension Committee through member induction and through papers and presentations delivered to members by officers and third party advisors. Examples include the triennial valuation of the Fund, the Fund's investment strategy, governance of the scheme and knowledge of asset classes. Officers and third party advisors will deliver additional training in areas set out in the modules in appendix B; training will accompany the Committee agenda when certain related papers are being presented and will form part of the two informal Pension Committee meetings.

4.8 Training will be delivered in the form of presentations by officers and advisors, who will include the Fund actuary, investment consultant, pension administrator and Fund's external lawyers. Training will be recorded and monitored by officers.

5. Key Strategies and Policies

5.1 There are a number of key policies and strategy documents which need to be kept under review for both the LGPS and FFPS. These are listed below and the latest version of these reports can be found on the pension fund website https://www.yourpension.org.uk/Hertfordshire/Fund-information/Policy-statements.aspx .

5.2 Annual Report

5.2.1 This report sets out the annual accounts for the Pension Fund, LGPS, for the previous financial year. Within the annual report are the following documents:

- Administering Authority report
- Financial Statements
- Investment Report
- Funding Strategy Statement

5.2.2 The annual accounts will be presented to this Committee in July along with the Auditors report following the audit of the accounts. Statements and notes relating to the FFPS are contained in the main accounts of the County Council. The latest audited version of the accounts can be found on the pension fund website https://www.yourpension.org.uk/Hertfordshire/Fund-information/Annual-reports.aspx .

5.3 Funding Strategy Statement (FSS)

5.3.1 This sets out the strategy for prudently meeting the Fund's future pension liabilities over the longer term, including the maintenance, as far as possible, of stable levels of employer contributions. It also identifies the key risks and controls facing the Fund and includes details of employer contribution rates following the triennial valuation of the Fund. The Fund was last valued at 31 March 2016 and the current FSS was approved by the Pension Committee on 7 March 2017. The next valuation of the Fund will take place on 31 March 2019. This document is only applicable to the LGPS and not the FFPS. As the next valuation year approaches in 2019, additional training on actuarial matters will be provided to this Committee so that they gain an understanding of why the Fund is valued every three years and the assumptions used to inform the valuation process,

5.4 Investment Strategy Statement

5.4.1 The Investment Strategy Statement (ISS) sets out the Hertfordshire Pension Fund's investment objectives. The Local Government Pension Scheme (Management and Investment of Funds) regulations 2016 require all pension funds to prepare, maintain and publish an ISS. This document is designed to explain to fund members, employers and any other interested parties how the Fund's assets are managed and the factors taken into account in so doing. The latest version of the ISS was approved by this Committee at its meeting held on 31 March 2017. This document is only applicable to the LGPS and not the FFPS. This strategy must be reviewed at least every three years with the next review due to take place in the financial year 2019/20.

5.5 **Communication Strategy**

5.5.1 This details how the Fund provides information and publicity about the Pension scheme to its existing members and their employers and methods of promoting the Pension scheme to prospective members and their employers. It also identifies the format, frequency and method of distributing such information or publicity. The current strategy was approved by this Committee on 4th September 2017.

5.6 **Governance Compliance Statement**

5.6.1 This is a written statement setting out the administering authority's compliance with good practice governance principles. These principles are grouped within eight categories which are listed within the statement. The principles cover areas such as structure, member representation, voting, meetings etc. It also sets out the functions delegated to the Pension Committee as well as the terms of reference for both the Pension Committee and Pension Boards. This statement is prepared in accordance with the Local Government Pension Scheme Regulations 2013 which require administering authorities to maintain and publish a governance compliance statement. This statement was approved by the Pension Committee on 4th September 2017.

5.7 **Administration Strategy**

5.7.1 The Pension Fund is committed to providing a high quality pension service to both members and scheme employers and ensuring that the Pension Fund is effectively governed. The administration strategy sets out standards and guidelines agreed between employers and the Fund and its aim is to set out the roles and responsibilities of the Pension Fund and its scheme employers in administering the Scheme. It seeks to promote good working relationships and improve efficiency between the Pension Fund and its scheme employers.

5.8 **Administering Authority Discretions Policy**

5.8.1 Regulations allow the County Council as the administering authority to choose how or whether to apply certain discretions for administering the scheme and the Pension Fund. Examples of discretions include the abatement of pensions for members returning to work, the award of death grants and purchase of additional pension through additional voluntary contributions. Employer bodies within the scheme will also have their own discretionary policies to cover areas such as flexible retirement, ill health awards and early retirement without deduction of pension.

6. Forward Plan

6.1 The following Forward Plan sets out the planned activities for the next financial year 2018/19. This plan may be amended to include additional activities relating to matters that must be brought to the attention of the Pensions Committee. The forward plan for 2018-19 is set out in Appendix A.

6.2 The agendas on the forward plan contain part 1 and part 2 items. Part 1 items are held in public and part 2 items are held after the exclusion of press and public and contain business that involves the disclosure of exempt information. Training will be provided to support Committee members to improve their knowledge and understanding of these activities.

Appendix A - Pensions Committee Forward Plan

Target Date	Agenda Item
10 July 2018	**PART 1**
	Audit Results Report – report of auditor Ernst & Young
	Response to the Audit Results Report 2016/17
	Pension Fund Annual Report and Statement of Accounts 2016/17
	Hymans Employer Asset Tracker (HEAT) Report
	ACCESS asset pooling quarterly report
	Asset de-risking transition report
	Risk and performance quarterly report
	PART 2
	Funding and investment quarterly report
5 September 2018	**PART 1**
	Risk register review and training
	ACCESS asset pooling quarterly report
	Pension Board constitution review
	Risk and performance quarterly report
	PART 2
	Funding and investment quarterly report
30 October 2018	**PART 2**
	Informal Pension Committee – managers attending and training tbc
20 November 2018	**PART 1**
	ACCESS asset pooling quarterly report
	Risk and performance quarterly report
	Actuarial Valuation planning and training
	PART 2
	Annual Investment Management Costs Report
	Funding and investment quarterly report
28 February 2019	**PART 1**
	ACCESS asset pooling quarterly report
	Risk and performance quarterly report
	Pension Fund Business Plan 2017/18
	Treasury Management Strategy 2018/19
	PART 2
	Funding and investment quarterly report
22nd March 2019	**PART 2**
	Investment Manager presentations – managers attending and training tbc

Appendix B – CIPFA Knowledge and Skills Framework

Module	Knowledge
1. Pensions Legislation	A general understanding of: • the pensions legislative framework in the UK. • An overall understanding of the legislation and statutory guidance specific to the scheme and the main features relating to benefits, administration and investment.
2. Pensions Governance	A knowledge of: • the role of the administering authority in relation to the LGPS. • An understanding of the role and powers of the various regulatory bodies such as MHCLG[2], Pensions Regulator, and Pension Ombudsman. • A broad understanding of the role of pension fund committees. • Knowledge of stakeholders of the Pension Fund and their interests. • Knowledge of consultation, communication and involvement options relevant to the stakeholders. • Knowledge of how pension fund management risk is monitored and managed. • An understanding of how breaches in law are reported.
3. Pensions Administration	A general understanding of: • Best practice in pensions administration eg. performance and cost measures. • Fund policies relating to member data maintenance and record keeping processes, internal dispute resolution, contributions collection and scheme communication and materials. • Discretionary powers • The Fund's pension administration strategy • Pensions Taxation • An understanding of AVC arrangements, including investment

[2] Ministry of Housing, Communities and Local Government.

	choices, investment performance and payment schedule.
4. Pensions accounting and auditing standards	An understanding of: • The financial accounts and audit regulations. • The role of both internal and external audit in the governance and assurance process.
5. Pensions services procurement and relationship management	An understanding of: • The background to public procurement policy and procedures. • Procurement requirements of UK and EU legislation. • The importance of considering risk factors when selecting third party providers. • How the Pension Fund monitors and manages the performance of their outsourced providers.
6. Investment performance and risk management	An understanding of: • The importance of monitoring assets returns relative to liabilities' • The assessment of long-term risks.
7. Financial markets and products knowledge	An understanding of: • The risk and return characteristics of the main asset classes (equities, bonds, property) • The role of these asset classes in long-term pension fund investing. • The importance of the investment strategy decision. • The workings of financial markets and the investment vehicles available to the pension fund. • The limits placed by regulation on the investment activities of local government pension funds.
8. Actuarial methods, standards and practices	An understanding of: • The role of the Fund actuary. • The valuation process, including the funding strategy, and inter-valuation monitoring. • The importance of monitoring early and ill health retirement strain costs. • The implications of including new employers into the Fund and cessation of existing employers. • The importance of the employer covenant and the relative strengths of the covenant across employers.

HERTFORDSHIRE COUNTY COUNCIL

Agenda Item No:

4

PENSIONS COMMITTEE
WEDNESDAY, 28 FEBRUARY 2018 AT 10:00AM

RISK AND PERFORMANCE

Report of the Director of Resources

Author of the report: Jolyon Adam, Finance Manager /James Kidd, Senior Accountant (Telephone: 01992 555078)

1. Purpose of the Report

1.1 To provide the quarterly update on Risk and Performance for the Pension Fund for the period 1 October to 31 December 2017.

2. Summary

2.1 The report provides an update on the following matters:

- summary of reports to be presented to the March meetings of the Pension Boards;
- current status of risk and governance matters that are monitored as part of the Risk Register;
- current status of risk monitoring of Scheme Employers; and
- performance of the Administering Authority measured against performance indicators set out in the Administration Strategy.

3. PENSION BOARD REPORTS

3.1 The Pension Committee are invited to note the following reports related to risk and performance that the LGPS and Fire Pension Boards will receive at their March meetings:

LGPS Board

- **Risk and Governance Report:**
  - Providing a detailed quarterly update on the governance and management of the Pension Fund.
- **London Pensions Fund Authority Administration Report:**
  - Providing a quarterly update on the performance of the administration service for the Local Government Pensions Scheme.
- **ACCESS Update:**
  - Providing an update on the current status of asset pooling.
- **Ceased Employers:**

- Officers have been requested to prepare a paper detailing all ceased employers with deferred or pensioner members, their funding positions, and relevant actions in relation to management of these.

- **Investment Management Costs:**
  - Officers have been requested to provide a copy of the report which was presented to the November meeting of the Pension Committee.

Fire Board

- **London Pensions Fund Authority Administration Report** providing a quarterly update on the performance of the administration service for the Firefighters' Pension Scheme

4. RISK REGISTER

4.1 The Risk Register sets out risk control mechanisms that aim to either avoid or reduce the probability and/or impact of any risk event in relation to the Pension Fund. Risks are classified using the following criteria.

Risk Level	Description
Severe	The consequences will have a severe impact on the delivery of a key priority and comprehensive management action is required immediately.
Significant	The consequences of the risk materialising would be significant, but not severe. Some immediate action is required plus the development of an action plan.
Material	Consequences of the risk are not significant and can be managed through contingency plans. Action plans can be developed later to address the risk.
Manageable	Consequences of the risk are considered relatively unimportant. The status of the risk should be reviewed periodically.

4.2 Table 1 provides the current risk status of the four key risks and a summary of activities undertaken during the quarter to December 2017. The risk status key is shown in the following chart.

▲	An increase in risk status since the previous quarter
◀▶	Risk status has remained unchanged since the previous quarter
▼	A decrease in risk status since the previous quarter

Table 1: Risk Register – Current Status and Activity Summary

Risk		Risk Level	Change in Risk Status	Quarterly Activity Summary
A	The Pension Fund Investment Strategy does not deliver the long term projected investments returns and does not comply with legislation.	**Amber**	◀▶	A procurement processes has been completed to select an Operator for the pool – and an announcement on the successful bidder will be made publicly in the coming weeks. A detailed update on ACCESS, is provided in a separate paper to this Committee. Officers have been carrying out significant transition work over the Winter in order to rebalance the investment portfolio in line with

				proposals agreed at the November Committee meeting, summarised as: • De-risking 10% of the investment portfolio from equities to index-linked bonds, in preparation of developing a real assets allocation. • Transitioning passively managed assets from the current manager to the ACCESS pool passive manager. • Making new allocations to private equity in order to maintain the Fund's 5% allocation to this asset class.
B	The funding level of the Pension Fund deteriorates.	**Amber**	◀▶	A quarterly update on funding is being presented to this committee which shows the funding position changing from 91% at the last valuation to 96% as at 31 December 2017. The deficit at this date has therefore fallen to £172m. The 2017 investment strategy is seeking to de-risk the fund away from equities, and move to protect the high funding level. As detailed above, de-risking is currently underway to reduce the Fund's exposure to equities into less volatile asset classes.
C	Scheme employers default on meeting their obligations to the Pension Fund and LGPS.	**Amber**	◀▶	The 16/17 Annual Benefit Statement exercise was completed in August, with all active members receiving their ABS statements by the deadline of 31st August. An issue has been identified with Fire ABS's in relation to information provided by SERCO/Herts HR to LPP. HR are currently investigating this issue. A review of 16/17 ABS exercise is underway to highlight employers who have not communicated changes in their members' circumstances to the LPP in a timely manner. The fund is in the process of contacting and working with these employers through the year in order to reduce the strain on

				LPP at year end.
D	The Pension Fund and its third party providers do not comply with regulations, statute or procedure.	**Green**	◀▶	Separate reports are being presented to the committee to update on the current status of asset pooling. The Administering Authority has been making use of external legal advice from Squires Patton Boggs when considering new or amended policies and processes to make sure that they are compliant with regulations. Officers are currently working with legal advisors and the Actuary to explore means of resolving cases of outstanding admission agreements for outsourced contracts.

5. SCHEME EMPLOYERS RISK MONITORING

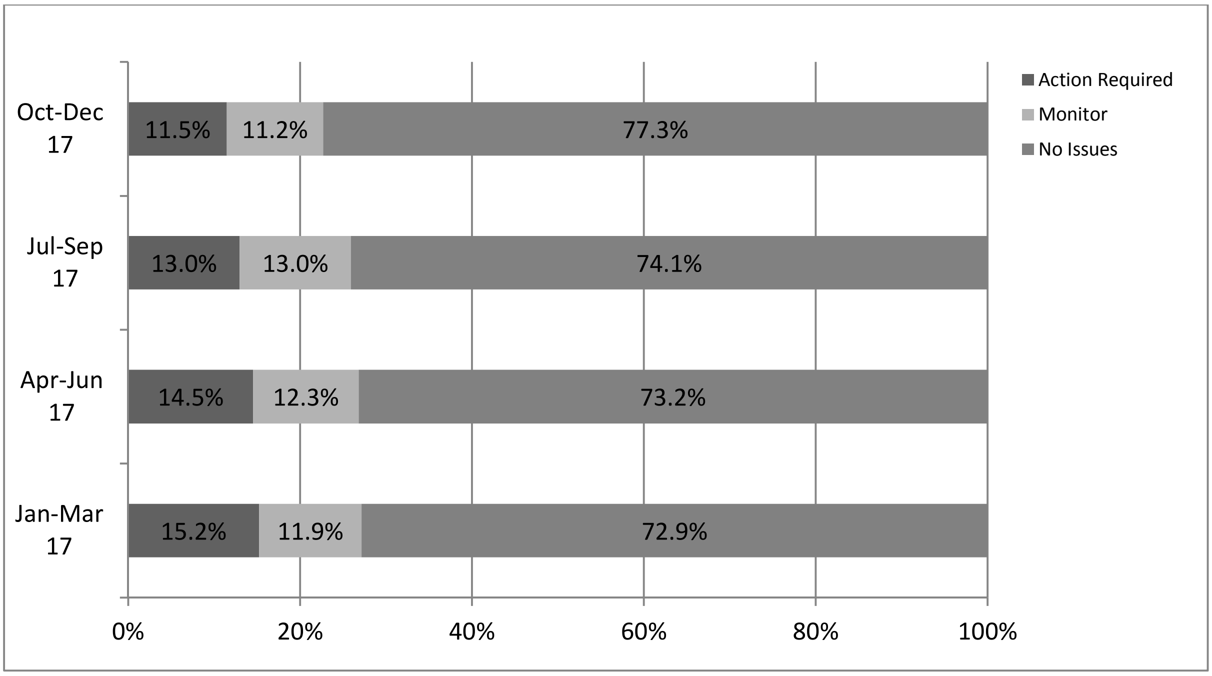
5.1 Scheme Employers are monitored on a monthly basis to measure the trend and current status of risk where scheme employers' covenants may have a detrimental impact on the Pension Fund.

5.2 Scheme employers are rated as:

- RED - high risk: This indicates that action is required to mitigate the risks to the Pension Fund where there is a high risk of a scheme employer defaulting on its obligations to the Pension Fund.
- AMBER - medium risk: This indicates that scheme employers require review or ongoing monitoring to determine whether any actions need to be taken to mitigate the risks identified.
- GREEN - low risk: This indicates that there are no immediate issues or actions to be taken.

5.3 Table 2 provides a summary of the current position, with comparative data for previous quarters to create a rolling-year illustration.

Table 2: Employer Risk Monitor – Current Trend and Status



5.4 Table 3 provides an analysis of the number of scheme employers in each risk category together with the value of net liabilities for each risk category.

Table 3: Analysis of Scheme Employers by Risk Category

July – September 2017					Risk Category / Risk Score	October – December 2017				
Scheme Employers		Net Assets/ (Liabilities)		Risk Score [1]		Scheme Employers		Net Assets/ (Liabilities)		Risk Score [1]
No.	%	£ m	%			No.	%	£ m	%	
46	13.0	4.5	(1.3)	12.7	**Red (9+)**	43	11.5	3.6	(1.1)	12.7
46	13.0	(66.5)	19.8	4.8	**Amber (4-8)**	42	11.2	(65.1)	19.3	4.4
263	74.0	(274.5)	81.6	0.6	**Green (0-3)**	290	77.3	(275.0)	81.7	0.6
355	**100.0**	**(336.5)**	**100.0**	**2.7**	**Total**	**375**	**100.0**	**(336.5)**	**100.0**	**2.4**

5.5 A further analysis detailing employers within the ‘red’ category with outstanding admission agreements has been provided at Appendix A. This action plan sets out the original reasons for the delay in each case, the current status of the agreements and the next steps for each case.

5.6 Table 4 below summarises the movements in number and age of outstanding Admission Agreements.

Table 4: Outstanding Admission Agreements

Time period since transfer	Q4 Jan-Mar 2017	Q1 Apr-Jun 2017	Q2 Sep-Jul 2017	Q3 Oct-Dec 2017
0-6 months	3	0	1	2
6-12 months	7	7	1	1
Over a year	16	18	16	16
Total	**26**	**25**	**18**	**19**

5.7 Appendix A outlines the Administering Authority's action plan for the remaining outstanding Admission Agreements.

6. ADMINISTERING AUTHORITY PERFORMANCE MONITORING

6.1 The performance of the Administering Authority and scheme employers in managing and administering the Pension Fund is measured against performance indicators set out in the Administration Strategy. This section also includes information about treasury management performance against the annual Treasury Management Strategy.

6.2 Table 5 provides the current status and commentary on the performance indicators. The performance status key is shown in the following chart.

▲	A deterioration in performance since the previous quarter
◀▶	Performance has remained unchanged since the previous quarter
▼	An improvement in performance since the previous quarter

Table 5: Administering Authority Performance Monitor

Indicator	Change in Performance Status	Commentary
Audit Reviews	◀▶	The annual (internal) administration audit of the Pension Fund's systems and processes was carried out in December 2017. This audit focused largely on the administration and systems largely operated by the LPP. The draft audit report has provided Substantial Assurance around the current controls in operation for administration processes. Once published as a final version, this report will be made available to the Committee. Officers have been working with the External Auditor to ensure that timetables are sufficiently advanced to ensure the accounts are completed by the 31 May (draft accounts) and 31 July 2018 (fully audited accounts) in order to meet the new Central Government 'faster close' deadlines.

		Preliminary timetabling and dates have been agreed with Ernst & Young such that they will commence their audit on 21st May – around three weeks earlier than in previous years. To ease year-end work pressures, EY have begun early audit testing, completing on-site testing in December with further work planned for February.
Complaints and Internal Disputes	◀▶	**Complaints:** During the quarter there were three new LPP service complaints. • A complaint was received from a member with regards to the delays in processing of a transfer in. Further investigation into the case has highlighted discrepancies in information supplied by the previous provider which were queried and revised information was provided. The member changed her decision to not transfer in her previous pension to the Hertfordshire Pension Fund. • A complaint was received regarding recovery of an overpayment and the distribution on an incorrect payslip. The pension payment had been recalled and the correct amount paid via an emergency payment, however the payslip showing the original amount had already been distributed which was misleading to the member. The Payroll Manager issued a letter of apology detailing the amendments to the pension record and any possible tax adjustments. • A complaint was received regarding delays in recalculating a pension. The error was due to a historical arrangement around what constitutes pensionable pay for two members of the pension scheme and was unknown by LPP. The case was expedited and revised information was securely emailed to the member with an apology. **IDRP:** During the quarter to 31 December 2017, one new IDRP was raised against the Administering Authority. • The stage 2 appeal submitted against the Administering Authority was regarding the overpayment of pension due to re-employment. The member was previously awarded £500 compensation and part of the

		overpayment was deemed unrecoverable. However, the member is appealing that decision requiring him to repay some pension back to the Hertfordshire Pension Fund. The County Council have partially upheld the appeal and awarded a further £400 compensation.
Scheme Employer Late Payments and Penalty Charges	◀▶	In the quarter to 31 December there were; • 6 incidents of late payment • 15 incidents of late return of monthly contribution forms. 8 penalty charges were raised against 5 scheme employers as a result of these incidents. Details of these late payments are reported in the LPP's quarterly Administration Report which is presented to the Pensions Board.
LPP Administration Service Performance Indicators	◀▶	Officers are working with the LPP to address the backlog of Defined Benefit cases, and develop the action plan already in place to continue to reduce this backlog in light of the one-off increases arising from year-end processes. The Pension Board is also monitoring this area closely to ensure that progress is delivered. A separate report is being presented to this meeting on the options to enforce admission bodies and ceding employers to finalise admission agreements in a timely manner. This follows proposals put forward by the Pensions Board and legal advice provided by the Fund's external legal consultant (Squire Patton Boggs).
Treasury Management	◀▶	The average size of the portfolio at 31st December 2017 was £23.7m increasing from £21.2m in the previous quarter. This is below the cap of £35m. Interest earned in the quarter to 31st December 2017 was £15.2k increasing from £9.8k in the previous quarter. The rate of return was 0.26% increasing from 0.19% in the previous quarter. This was 0.09% above the benchmark of the average 7 day London Interbank Bid (LIBID) rate of 0.17%

APPENDIX A OUTSTANDING ADMISSION AGREEMENT ACTION PLAN (AS AT 31/12/17)

No.	Risk category	Reason for delay	Summary of current position	Action plan
DELAY IN ADMISSION BODY PROVIDING INFORMATION				
1-2	1 Year +	Delay in admission body providing information	Hertfordshire County Council Legal liaising with employer to progress Admission Agreement and Bond however there is a lack of response from the admission body	Hertfordshire County Council Finance have escalated with the contract manager who has chased the contractor but with no response. This will now be escalated further with the ceding employer and admission body
DELAY IN ADMISSION BODY SECURING INDEMNITY				
3	1 Year +	Delay in admission body securing bond	Employer enquiring about an alternative form of indemnity, a cash deposit for the bond value placed with Hertfordshire County Council in escrow. The Actuary has advised there is no issue with accepting this	Hertfordshire County Council Finance looking at potential to accept this form of indemnity before providing response to employer
4	1 Year +	Delay in admission body securing bond	Bond options have been provided by Hertfordshire County Council Finance and employer is currently seeking a provider before Finance is able to pass to Hertfordshire County Council Legal to formalise admission	Awaiting confirmation of sourced bond from employer before continuing to progress Admission Agreement with Hertfordshire County Council Legal
5	1 Year +	Delay in admission body securing bond	Hertfordshire County Council Finance have responded to all queries from the employer regarding the bond value and are awaiting a response	Awaiting confirmation of sourced bond from employer before continuing to progress Admission Agreement with Hertfordshire County Council Legal
6	1 Year +	Delay in admission body securing bond	Requirement to have a bond in place questioned by employer, Hertfordshire County Council have responded and awaiting response	Awaiting confirmation of sourced bond from employer before continuing to progress Admission Agreement with Hertfordshire County Council Legal

No.	Risk category	Reason for delay	Summary of current position	Action plan
DELAY IN ADMISSION BODY RETURNING SIGNED DOCUMENTS				
7	1 Year +	Delay in admission body returning signed documents	Bond agreement signed-off and returned. Waiting on returned signed copy of Admission Agreement	Bond agreement signed-off and returned. Waiting on returned signed copy of Admission Agreement
8	1 Year +	Delay in admission body returning signed documents	7 Local Authorities party to Admission Agreement, Hertfordshire County Council Legal sent copies out to all for sign-off and received 4 out of 7 to date	4 out of 7 signed copies of the Admission Agreement returned, awaiting return of the rest
DISPUTE OVER CONDITIONS OF ADMISSION				
9	1 Year +	Dispute over conditions of admission	Hymans calculated employer contribution rate which is high and has been queried by the employer	Hertfordshire County Council Finance (in liaison with Legal and the Actuary) are looking at a 'pass through' arrangement in such events where the contribution rate is so high in order to progress
10	1 Year +	Dispute over conditions of admission	Hymans calculated employer contribution rate which is high and has been queried by the employer	Hertfordshire County Council Finance (in liaison with Legal and the Actuary) are looking at a 'pass through' arrangement in such events where the contribution rate is so high in order to progress
11	1 Year +	Dispute over conditions of admission	Legal opinion to be sought by Hertfordshire County Council from Squires	Hertfordshire County Council Finance and Legal to draft e-mail
12	1 Year +	Dispute over conditions of admission	Talking with ceding employer to establish whether the two staff that TUPE'd are still working on the contract, if not there may not be a need to pursue completion of an Admission Agreement	Hertfordshire County Council Finance waiting for response from the ceding employer to establish facts around whether admission is required.
THIRD PARTY DELAY				

No.	Risk category	Reason for delay	Summary of current position	Action plan
13	1 Year +	Delays in the actuarial calculations due to a backlog following the 2016 Triennial Valuation	Admission Agreement was awaiting sign-off however the last active member left in August and the AA may not need to be completed	Hertfordshire County Council Finance to check that last active employee had opted out of pension and therefore no contributions were required to be collected. If so, this entry can be removed
14	1 Year +	Third party delay	Reports now obtained from the actuary which will be shared with employer. Assuming no disputes it will then be progressed by HCC Legal	Reports to be shared with employer and assuming no disputes will then be progressed to Hertfordshire County Council Legal
15	1 Year +	Third party delay	Admission and Bond Agreements sent out to employer waiting for confirmation of bond sourced and return of signed documents	Hertfordshire County Council Finance chasing employer for a response
16	1 Year +	Third party delay	There was some delay in making indemnity arrangements but now this is with Hertfordshire County Council Legal to draft Admission Agreement	With Hertfordshire County Council Legal to draft Admission Agreement and once complete will be shared with parties for sign-off
17	6-12 Months	Delay in the actuarial calculations due to a backlog following the 2016 Triennial Valuation	Contribution Rate and Bond calculated. Information passed to Hertfordshire County Council Legal to draft Admission Agreement	With Hertfordshire County Council Legal to draft Admission Agreement and once complete will be shared with parties for sign-off
18	0-6 Months	Third party delay	With Hertfordshire County Council Legal to draft Admission Agreement	With Hertfordshire County Council Legal to draft Admission Agreement and once complete will be shared with parties for sign-off
19	0-6 Months	Third party delay	With Hertfordshire County Council Legal to draft Admission Agreement	With Hertfordshire County Council Legal to draft Admission Agreement and once complete will be shared with parties for sign-off

TOTAL: 19 OUTSTANDING ADMISSION AGREEMENTS

HERTFORDSHIRE COUNTY COUNCIL

PENSIONS COMMITTEE
WEDNESDAY, 28 FEBRUARY 2018 AT 10:00AM

Agenda Item No:
5

ACCOUNTING ISSUE - EMPLOYER JULY & AUGUST 2017 FRS102 REPORTS

Report of the Director of Resources

Author of the report: Jolyon Adam, Finance Manager /James Kidd, Senior Accountant (Telephone: 01992 555078)

1. Purpose of the Report

1.1 To provide the Pensions Committee with an overview of the misstatement in investment returns which led to the re-issue of FRS102 reports to a number of employers in December 2017, and additional cost incurred by the Pension Fund.

2. Recommendations

2.1 That the Pension Committee notes the content of this report.

3. Background

3.1 Academies and colleges are required to report under Financial Reporting Standard (FRS) 102, which dictates the information and disclosures required within their Statement of Accounts in relation to defined benefit pension schemes.

3.2 Academies within the Fund prepare their accounts in line with FRS guidance with a year-end date of 31st August. Higher Education and Further Education employers also prepare their accounts in line with FRS guidance, but instead have a year-end date of 31st July.

3.3 The fund's Actuary (Hymans Robertson) produce FRS102 reports for all employers within the fund who request a report. The Fund pays for these reports to be produced, and recharges the costs onto each employer.

3.4 Hymans Robertson calculates the figures required for each report using actuarial assumptions, the employer's payroll and membership data, and the return on investments experienced for 12 months prior to the reporting date.

3.5 Officers in Herts Finance provide Hymans Robertson with asset valuations and the percentage (%) return for the Fund's investments, on a quarterly basis. This information is extracted from reports from the fund's Custodian (BNY Mellon) and the fund's external investment consultant (Mercer)

3.6 Due to the time-lag in availability of full asset valuation data from Fund Managers/the Custodian, Hymans will routinely have to calculate valuations on a 'roll-forward' approach. For example, Hymans will receive quarterly returns data up to 30 June, but for those bodies with a 31 July year end, the returns for the subsequent month will be estimated.

4. Issue

4.1 As part of the July and August 2017 FRS102 reporting exercise, Hymans Robertson requested the actual returns on fund investments up to 30th June 2017. This data is provided by the Fund's custodian (BNY Mellon) and investment consultant (Mercer) and analysed into the appropriate format by officers.

4.2 Data on fund returns for Q4 2016/17 and Q1 2017/18 (01.01.2017- 31.03.2017 & 01.04.2017 – 30.06.2017) was mistakenly extracted from the wrong Mercer performance period reports into the Hymans data capture spreadsheet. This was a result of human error on the part of the Officer compiling the submission. This resulted in the returns for these quarters being overstated, as the data used related to previous quarters, when asset returns were higher. The originally submitted and corrected asset returns are shown in the table below:

Period	Original Submission	Corrected Submission
01.04.16 – 30.06.16	3.60%	3.60%
01.07.16 – 30.09.16	7.10%	7.10%
01.10.16 – 31.12.16	2.30%	2.30%
01.01.17 – 31.03.17	6.10%	3.70%
01.04.17 – 30.06.17	3.70%	1.50%

4.3 Internal controls within the team responsible for the Fund in Herts Finance were not sufficient to identify the incorrectly entered data, and the misstated returns were sent to Hymans Robertson.

4.4 Hymans Robertson used the figures provided when producing employers' FRS102 reports, which yielded the following returns for employers reporting to each of the two financial periods affected:

Returns from 1 August 2016 to 31 July 2017 – 15.7%
Returns from 1 September 2016 to 31 August 2017 - 16.6%

Whereas these should have been:

Returns from 1 August 2016 to 31 July 2017 – 10.7%
Returns from 1 September 2016 to 31 August 2017 - 11.6%

4.5 The FRS102 reports were sent to 6 employers with a 31 July 2017 year-end, and 96 employers with a 31 August 2017 year-end. The affected employers are listed in Appendix A.

4.6 Initial Asset Allocation (IAA) reports were also sent to 11 employers seeking admission to the Fund, outlining the liabilities at the point of transfer, and an indication of the value of assets to be allocated to the employers to cover this.

4.7 The misstatement was noticed by Fund Officers after querying with Hymans that the overall explanation around the increase in the funding level included in the latest Hymans 'Navigator' report did not tally with knowledge of recent asset performance. The root cause of this misstatement was then identified in the last week of November 2017.

5. Impact

5.1 As a result of the misstated investment returns, there were various figures within the FRS102 Reports which were also misstated:

- Actual Returns and Total Returns were overstated by c. 5%.
- A number of Balance Sheet, Profit & Loss and 'Other Comprehensive Income' Disclosures were affected:
    - 'Return on assets excluding amounts included in net interest' was overstated, which impacted upon 'Total remeasurements recognised in Other Comprehensive Income (OCI)'.
    - 'Fair value of plan assets' was overstated, resulting in an overstatement in the closing position of c.5%.
- Projected defined benefit cost - 'Interest income on plan assets' was overstated, resulting in the 'Total Net Interest Cost' (included in profit and loss) being overstated. The difference here was likely immaterial to most employers at around 0.125%.

5.2 The Initial Asset Allocation (IAA) reports had overstated initial funding levels.

5.3 The Education Schools Funding Account require all academies to submit their financial statements by 31st December to the Department for Education. Fines are imposed on Academies who fail to meet this deadline.

6. Action Taken

6.1 Once the issue was identified Hymans Robertson were urgently requested to re-calculate three reports to assess the impact of the misstatement on affected employers' accounts, in order to dictate the appropriate rectification actions.

6.2 This analysis concluded that the c.5% overstatement of the 'Fair Value of Plan Assets' would likely lead to a material effect on employers' balance sheets and profit & loss statements. The IAA reports do not feed directly into employers' financial accounts, but instead would need to reconcile to the first FRS102 report the employer would receive, so officers felt it was necessary to reissue these as well.

6.3 A number of cessation reports had been produced, but not issued to employers – these also required revisions, as funding positions would have been overstated by the incorrect level of asset returns. Hymans Robertson offered to revise these reports free of charge.

6.4 The charges for the usual FRS102 report exercise for all employers is recharged onto the employer requiring the report. As the misstatement was not due to an error by any employers, the fund stated that no employer would be recharged for the cost of revising the reports.

6.5 Hertfordshire Pension Fund officers requested a full list of employers who received a FRS102 report in July or August, and those who received an IAA report between March 2017 and September 2017.

6.6 All employers affected by the FRS102 report misstatement were emailed a letter on 4th December 2017 to inform them of the issue and the scale of the impact. Employers were informed that the reports would be re-issued during that week, and invited to indicate if they had a urgent requirement for their report to be prioritised e.g. imminent Governor's meeting to sign off their accounts.

6.7 Employers affected by the IAA misstatement were emailed on 5th December 2017.

6.8 Prioritised FRS102 reports were issued on 5th December – where Academies had indicated an urgent need. Remaining revised FRS102 reports were re-issued by 6th December 2017. IAA reports were distributed by 14th December 2017.

6.9 A quote for all of the FRS102 and IAA reports to be re-issued was requested. Hymans Robertson offered to carry this work out for the following discounted costs;

Report	**Total cost to re-issue**	**No. of reports**	**Cost per report**	**Average cost on original issue**
FRS102 July Reports	£2,100	6	£350	£608*
FRS102 August Reports	£24,000	96	£250	£429*
IAA reports	£4,400	11	£400	£750

*Some employers requested and required bespoke assumptions, which Hymans Robertson will quote for accordingly.

6.10 This issue was initially raised at the Pension Committee meeting on 29 November 2017, when this full report was commissioned. The issue was also discussed in greater detail at the Pension Board meeting of 8 December 2017, as more information was available, and where representatives of affected employer groups were present.

7. Outcome & Financial Cost

7.1 Following the initial contact (4 December 2017), a number of academies stated that they were due to sign off their accounts in the following days. These employers' reports were prioritised to be re-issued first on 5th December.

7.2 A number of employers responded to the re-issued report to state that additional work had to be undertaken by their auditors and/or their (externally sourced) accountants. The fund outlined that employers would be reimbursed for any reasonable additional costs incurred as a result of the misstatement. Employers were asked to invoice the fund for the reimbursement. To date, ten employers have invoiced the fund for additional fees incurred.

7.3 At the time of writing (7th February 2018), the financial impact of the misstatement is as follows;

Cost of all reports (detailed in 6.3) =	£30,500
Reimbursement of auditor/accountant fees =	£2,823
Total financial impact to the fund =	**£33,323**

7.4 Hertfordshire County Council, as Administering Authority of the Fund, have agreed that the above administrative cost outlined in 7.3 be allocated to the Council and included as part of its liabilities in the Fund, so as to not impact other employers in the Fund.

8. Enhanced Controls

8.1 All officers responsible for the fund have been informed on the issue, understand how this occurred, and understand the scale of the impact caused by this.

8.2 Officers consider that current controls systems in place are robust, however given this occurrence a review is underway of all external data submissions from the Hertfordshire Pension Team, to ensure that appropriate controls are in place for all processes, which are proportionate to the level of impact should an issue arise.

8.3 The process involved in providing the quarterly asset returns data required to Hymans Robertson has been reformatted. This now includes a reconciliation between performance data from BNY Mellon and Mercer to ensure consistency prior to submission.

8.4 Hymans Robertson will be sent the supporting evidence for investment returns from both BNY Mellon and Mercer in order to cross reference this.

8.5 The data produced by HCC Finance is to be reviewed by the Senior Accountant or Finance Manager for the fund before forwarding to Hymans Robertson.

8.6 Hymans Robertson has been instructed to not accept any data which does not meet the requirements in 8.2-8.4.

8.7 Hymans Robertson have been instructed to inform officers of any discrepancy they identify before reports are issued to employers.

Appendix A

List of affected employers

FRS102 - 31 August Year End		FRS102 - 31 August Year End & Initial Asset Allocation		FRS102 – 31 July Year End		Initial Asset Allocation only	
397	Alban City Free School	538	Camps Hill Academy	143 & 198	University of Hertfordshire	545	Oxhey Wood
361	AppleCroft	539	Fairland Academy	166	Hertfordshire Regional College	547	Warren Dell
389	Beaumont School (Academy)	540	Churchfield Academy	167	North Herts College	548	Wilbury Junior
407	Berrygrove	541	Roebuck Academy	168	Oaklands College	549	Bedmond Academy
353	Birchwood High School			169	West Herts College	551	Alban Wood Primary
359	Bishop's Hatfield Girls School			221	University Bus	554	Grange Junior
327	Bovingdon Primary Academy					557	Croxley Danes
317	Broxbourne Academy						
363 & 364	Bushey St James Trust						
332	Chauncy School (Academy)						
429	Christ Church C of E School						
443	Countess Anne						
445 & 446	Crabtree MAT (Infants and Juniors)						
525	Cranbourne School						
406	Da Vinci Studio School						
337	Dame Alice Owen's School						
478	Elstree UTC						
492	Fair Field Academy						
428	Flamstead End Academy						
340	Freman College (Academy)						
410	Garden City Academy						
346	Goffs School (Academy)						
498	Hailey Hall School						
499	Haileybury Turnford						
331	Hammond Academy						
529	Harpenden Academy						

405	Hatfield Community Free School						
468	Herts and Essex Academy						
375	Hertswood Lower School						
417	Hitchin Boys School						
328	Hitchin Girls School						
365	John Henry Newman School						
414	Kings Langley School						
401	Knightsfield						
530	Larwood School						
531	Laurance Haines School						
418	Links ESC						
329	Longdean School (Academy)						
381	Loreto College						
371	Marlborough School						
307 & 306	Meller Educational Trust (Bushey Academy, Francis Combe Academy)						
408	Monkswalk School (Academy)						
330	Mount Grace School						
367	Nicholas Breakspear School (AC						
399	Northgate Primary Sch Trust AC						
358	Onslow St Audrey's School						
388	Our Lady Catholic School						
326	Parmiters School (Academy)						
469	Pinewood School						
372	Presdales School						
339	Queens School (Academy)						
374	Ralph Sadleir School						
370	Richard Hale School						
336	Rickmansworth School (Academy)						
524	Robert Barclay (previously Sheredes School)						
526	Roselands School						

341	Roundwood Park School						
355, 356 & 357	Royston Schools Academy Trust						
396	SAINT MARY'S RC PRIMARY						
409	Samuel Ryder Academy						
324	Sandringham School Academy Trust						
449	Simon Balle School						
345	Sir John Lawes School						
376, 377, 421 & 430	Spiral Academies Trust						
347	St Albans Girls School						
393	St Catherine of Siena						
338	St Clement Danes School						
392	St George's School (Academy)						
366	St Joan of Arc RC School						
391	St John's Catholic Primary						
384	St Mary's CofE High School						
398	St Marys Trading Ltd(Allsorts)						
368	St Michael's RC School						
390	St Thomas More (Academy)						
362	Stanborough						
343	Summercroft Primary School						
325	The John Warner School						
320	The Knights Templar School						
342	The Leventhorpe School						
369	The Sele School						
382	The Wroxham School						
442	Thomas Alleyne						
383	Tring School						
333	Verulam School (Academy)						
334	Watford Boys (Academy)						
335	Watford Girls (Academy)						
486, 484, 485 & 470	West Herts Community Free School Trust						
441	Westfield CTC						
467	Wilshere Dacre Junior						

	Academy						
490	Windhill School						
373	Woolgrove						
323	Yavneh College (Academy)						

HERTFORDSHIRE COUNTY COUNCIL

Agenda Item No: 6

PENSIONS COMMITTEE
WEDNESDAY, 28 FEBRUARY 2018 AT 10:00AM

2018/19 TREASURY MANAGEMENT STRATEGY FOR PENSION FUND

Report of the Director of Resources

Author of the report: Jolyon Adam, Finance Manager (Telephone: 01992 555078)

1. Purpose of the Report

1.1. To propose the 2018/19 Treasury Management Strategy (TMS) for the investment of Pension Fund cash held by the Administering Authority.

2. Summary

2.1. A treasury management strategy is prepared annually and approved by the Pension Committee, to provide clarity about the management of funds held locally for cashflow purposes.

2.2. During 2017/18 a cap of £35m was in place for funds held by the Administering Authority for cashflow purposes. These funds are managed to ensure that there is cash available for the payment of membership benefits and to fund cash drawdowns for the Fund’s property and private equity Investment Managers. The Fund’s benchmark allocation to cash is 1% of total pension fund assets – therefore it is proposed to increase this cap to £42m in line with the asset values as reported in the most recent set of audited accounts (2016/17).

2.3. This report sets out the proposed 2018/19 Treasury Management Strategy for the Pension Fund which will be effective from 1 April 2018.

3. Recommendations

3.1. It is recommended that the Pension Committee approves the proposed 2018/19 Treasury Management Strategy for lending Pension Fund cash which is set out in Appendix A.

3.2. It is recommended that the Pension Committee approve the increase of the cap for locally held funds to £42m, in line with 1% of Fund assets.

4. Background

4.1. The LGPS (Management and Investment of Funds) Regulations 2016[1] require Pension Fund cash managed by the Administering Authority be held in a separate bank account. A separate Pension Fund Treasury Management Strategy is prepared to provide clarity about the investment arrangements of Pension Fund cash managed by the Administering Authority.

4.2. The Pension Fund's Treasury Management Strategy (TMS) is based on the County Council's Strategy which is revised and approved on an annual basis in accordance with CIPFA's Treasury Management in the Public Services: Code of Practice 2011 and the Department for Communities and Local Government (DCLG) "Guidance on Local Authority Investments". A more limited range of investment instruments are used by the Pension Fund to reflect that the funds are held to meet short term cash flow requirements only, such as the payment of pensions.

4.3. In accordance with the current Ministry for Housing, Communities & Local Government (MHCLG) Guidance, the Pensions Committee will be asked to approve a revised Treasury Management Strategy Statement, should the assumptions on which this report is based change significantly. Such circumstances would include, for example, a large unexpected change in interest rates.

4.4. CiPFA and the MHCLG are in the process of issuing new codes of practice and guidance on investments and treasury management – however as this guidance is still being issued authorities are being advised[2] to base their TMS's on existing guidance. It is not expected that the new codes of practice or investment guidance will have a significant impact on the Fund's TMS.

4.5. In January 2018 the FCA implemented the Markets in Financial Instruments Directive (MIFID) II. MiFID II is a package of EU legislation introduced in 2014 to regulate both retail and wholesale investment business. Under the previous MIFID I framework Local Authorities and their Pension Funds were classified by default as 'professional investors'. Under MIFID II the default position shifted to 'retail investors' which would significantly limit the financial instruments and assets in which the Fund could invest. Officers successfully completed opt-up processes, as authorised by the Pension Committee in September 2017, to maintain the Fund's professional classification with all investment counterparties prior to the January 2018 implementation.

5. Current Lending Position and Economic Context

5.1. Funds held by the Administering Authority are required for short-term cashflow requirements, where the bulk of contribution income received each month

[1] http://www.legislation.gov.uk/uksi/2016/946/contents/made
[2] By Arlingclose, the Council's Treasury Advisors.

funds pensions payroll. Therefore, funds are generally held in immediate access accounts, such as call accounts and Money Market Funds.

5.2. Table 1 provides an analysis of funds held by the Administering Authority at 31 December 2017.

Table 1 Funds held at 31 December 2017

Total Funds at 31 December 2017	**Balance £000s**	**Interest Rate %**
Analysed as:		
Barclays Bank Call Account	1,511	0.40%
Money Market Funds:	**22,079**	**0.32%**
• Standard Life Sterling Liquidity	5,000	0.35%
• Insight Liquidity Sterling	5,000	0.34%
• Deutsch Managed Sterling	5,000	0.31%
• Goldman Sachs Sterling Liquid Institutional	5,000	0.31%
• Aberdeen Liquidity Fund Sterling	629	0.31%
• JP Morgan Sterling Liquidity Capital	1,450	0.29%

6. Proposed Treasury Management Strategy

6.1. The Fund's benchmark allocation to cash is 1% of the total Fund assets and it is suggested that the cap on cash held by the Administering Body be updated in line with the most recent set of audited accounts (for the Financial Year 2016/17). The Fund assets at 31 March 2017 were £4.243bn; therefore the cap will be updated to £42m. Where cash balances managed locally are approaching the cap it is proposed that these funds are distributed to Investment Managers in accordance with the Pension Fund's Investment Strategy. The Chief Financial Officer will authorise further distributions of funds to Investment Managers after taking advice from Mercer and following agreement by the Chair of the Pensions Committee. Any such distributions will be reported to the Pensions Committee at the next available meeting.

6.2. As with the County Council's treasury management strategy, the principal consideration when investing Pension Fund cash will be security of invested capital. The secondary consideration will be liquidity, to ensure that there is always enough cash available to pay pension benefits and cash drawdowns required by property and private equity Investment Managers. Only once both of these factors are satisfied will yield be considered.

6.3. The Monetary Policy Committee (MPC) of the Bank of England voted to raise the base rate of interest to 0.5% in November 2017, and in February 2018 suggested that future rate rises might be sooner, and larger than previously anticipated. The possibility for future recession in the UK is receding therefore, however rates remain at historic lows, and there is a small chance of negative interest rates should the UK find itself in a recession. This circumstance would likely feed through to negative interest rates on all low risk, short-term investment options. This situation has already been seen in other European countries. In this event, security will be measured as receiving the contractually agreed amount at maturity, even though this may be less than the amount initially invested.

6.4. The Pensions Fund's TMS is generally more prudent than the County Council's, to reflect the lower balances held by the Pension Fund as illustrated in Table 1, that these are held for the short term, and that they are held principally for liquidity to facilitate payment of benefits.

6.5. The proposed 2018/19 Treasury Management Strategy has considered a full range of risks and Officers will apply the Strategy to ensure that security of deposits is the prime consideration. However, in agreeing the proposed Strategy, Members should be aware that there is always a risk of default of counterparties other than the Debt Management Office (DMO) which is guaranteed by the UK Government.

6.6. Information on local treasury management balances and performance will continue to be provided on a quarterly basis to the Pensions Committee.

APPENDIX A: PROPOSED TREASURY MANAGEMENT LENDING POLICY 2018/19

1. Policy for determining which institutions should be on the lending list

1.1. The Pension Fund cash will be lent to the following types of institutions:

- Central Government
- Local Authorities
- UK Banks and Building Societies meeting the credit rating criteria set out in Table A
- Banks domiciled in other countries or their subsidiaries domiciled in the UK, providing the country has a sovereign rating of at least AA+ from each of the three credit rating agencies and the bank meets the credit rating criteria set out below. If the ratings of a parent bank fall below the minimum criteria, no lending will be undertaken with its subsidiaries even if their ratings continue to meet the minimum criteria (excepting Santander UK plc and Clydesdale Bank plc - see notes on overseas banks following Table A)
- Supranational banks (e.g. the European Investment Bank and the World Bank).
- AAA rated Money Market Funds
- The Pension Fund's bank. If it does not meet the criteria for UK Banks then the Bank will be used for small balances up to £1m.

1.2 The Pension Fund will make investments using the following types of financial instruments. See sections 1.8 to 1.10 for further information on these investments.

- Call and notice accounts
- Fixed Term deposits
- Money Market Funds

1.3 The Pension Fund will apply the credit rating criteria set out in Table A for investments with UK Government, Local Authorities and unsecured investments with Banks and Building Societies and other institutions based on Fitch's long term credit rating criteria.

Table A Minimum credit rating criteria

Counterparty	Limits		
	Long term	Time	£
Sovereign (country) rating	AA+	N/A	N/A
UK Government	N/A	364 days	Unlimited
UK Local Authorities	N/A	364 days	£4.2m
Standalone Banks	A-	364 days	£4.2m
Rated Building Societies	A-	364 days	£4.2m
Supranational Banks	AA+	364 days	£4.2m
Money Market Funds	N/A	7 days notice	£8.4m
	Asset Value		
Unrated Building Societies	£1.0bn	6 months	£2.1m
	£0.5bn	3 months	£2.1m

1.4 Credit Ratings

Investment decisions are made by reference to the lowest published long-term credit rating from Fitch, Moody's or Standard & Poor's. Where available, the credit rating relevant to the specific investment or class of investment issued, otherwise the counterparty credit rating is used. If an agency removes one of the set of ratings it issues for a bank or building society, the institution will be removed from the list. Table B provides a comparison of long term credit ratings for all agencies.

Table B Comparison of credit ratings for all agencies providing ratings

Fitch	Moody's	S&P	Definition
AAA	Aaa	AAA	Prime
AA+	Aa1	AA+	High Grade High Quality
AA	Aa2	AA	
AA-	Aa3	AA-	
A+	A1	A+	Upper Medium Grade
A	A2	A	
A-	A3	A-	
BBB+	Baa1	BBB+	Adequate Grade
BBB	Baa2	BBB	
BBB-	Baa3	BBB-	

1.5 The Pension Fund will continue to invest in UK institutions, e.g. banks, central government and MMF, even if the UK was not rated AA+.

1.6 Overseas subsidiaries of foreign banking groups will normally be assessed according to the country of domicile of the parent organisation. For the avoidance of doubt, Santander UK plc (a subsidiary of Spain's Banco Santander) will be classed as a UK bank due to their substantial UK franchises and the arms-length nature of the parent-subsidiary relationship.

1.7 Sovereign credit rating criteria will not apply to investments in multilateral development banks (e.g. the European Investment Bank and the World Bank) or other supranational organisations.

1.8 **Banks Unsecured**
This relates to accounts, deposits, certificates of deposit and senior unsecured bonds with banks and building societies, other than multilateral development banks. These investments are subject to the risk of credit loss via a bail-in should the regulator determine that the bank is failing or likely to fail.

Unsecured investment with banks rated BBB or BBB- are restricted to overnight deposits at the Pension Fund's bank, Barclays Bank plc.

1.9 **Government**
Investments in this category are loans, bonds and bills issued or guaranteed by national governments, regional and local authorities and multilateral development banks. These investments are not subject to bail-in, and there is an insignificant risk of insolvency.

1.10 **Money Market Funds (Pooled Funds)**
These are shares in diversified investment vehicles consisting of any of the investment types above, plus equity shares and property. These funds provide wide investment risk diversification, coupled with the services of a professional fund manager in return for a fee. Money Market Funds that offer same-day liquidity and aim for a constant net asset value will be used as an alternative to instant access bank accounts. The Fund will only utilise AAA(m/mf) rated funds, which have to meet strict criteria regarding capital preservation and liquidity. The average credit rating of the underlying assets within these funds will usually fall between A+ and AA-.

2. Policy for determining limits for deposits

Table C and the following notes in this section set out the limits to be applied on investments in addition to the investment counterparty limits shown in Table A.

Table C: Limits on Investments

Type	Description	Limit
Cap	The maximum amount of cash to be held and invested by the Administering Authority	£42 m
Maximum Transaction Value	The maximum deposit size when placing funds for fixed terms in order to spread risk. The only exceptions to this are deposits with the DMADF and Money Market Funds.	£4.2 m
Fixed Term Deposits	The maximum amount as a single transaction when placing fixed term deposits. The only exceptions to this are deposits with the DMADF and movements in and out of call accounts and pooled funds.	£4.2 m per transaction
Banking Groups	A group limit will apply where a number of banks are owned by a single institution.	£8.4 m per Group
Money Market	Total investment in any one Money Market	£8.4m per Fund

Funds	Fund	
Money Market Fund Groups	A group limit will apply where a number of Money Market Funds are owned by a single institution.	£16.8m per Group
UK Country Limit	Maximum percentage of portfolio permitted to be in UK institutions	100% investment portfolio
Non-UK Country Limit	Maximum percentage of portfolio permitted to be in non-UK institutions (excluding Money Market Funds)	£16.8m investment portfolio
Single Non-UK Country	Maximum percentage of portfolio permitted to be in any one country, other than UK	£4.2m of investment portfolio
Sector	A sector limit applies to unsecured investments in Building Societies to limit exposure to a common risk factor – in this case the property market	£16.8m investment portfolio

3. Policy to be followed when credit ratings change

3.1 Negative Watch

A status that credit rating agencies apply while they are deciding whether to lower that organisation's credit rating.

- If an institution is on negative rating watch the Council will treat it as one credit rating lower than it is currently rated.
- If an institution is at the bottom of the Council's credit rating criteria and is placed on negative watch, the Council will stop investing and attempt to call back any money which is currently invested, depending on the economic viability of withdrawing the investment.

This policy does not apply to a negative outlook on a credit rating. In the case of a negative outlook any investment decision will be considered in line with all other information available but will not prompt immediate action to review existing investments.

3.2 Downgrading

- If an institution is downgraded below the minimum credit rating criteria, then it will be removed from the list with immediate effect, along with any subsidiaries, and no new investments will be made.
- If funds are on call with an institution when a downgrade happens, they will be withdrawn or the balance reduced as appropriate, at the earliest possible opportunity, which may be the following working day.
- If there are outstanding fixed term deposits with an institution which has been removed from the list, terms for repayment will be sought and, if offered, fully considered and documented by Officers.
- Downgradings and the action taken will be reported in the weekly treasury management meetings and quarterly reports to members.

4. Other matters to be considered by Officers

4.1 In applying the policy set out above, Officers will refer to the following sources of market information on a regular basis:

- Credit Default Swap Rates
- Equity Prices
- Economic data
- Financial statements
- Outlook reports from credit agencies
- Financial Times and other news sources
- Professional journals and other publications

4.2 A regular briefing will be provided for all Officers involved in the dealing function, the Head of Finance – Pensions & Treasury and/or the Assistant Director of Finance. This will provide all relevant information to enable decisions to be taken about treasury activity to ensure this remains within the policy. By its very nature the information will not be definitive and Officers will do all they can to react to these sources of information with the primary objective of security. The briefings will generally be delivered via weekly meetings. If for any reason, a meeting cannot be convened, then all relevant information will be circulated to Officers and the Assistant Director of Finance.

4.3 Officers maintain an overview of prevailing market rates in their regular contact with brokers. When considering fixed term deposits, Officers will consider quotes from brokers for a range of periods before making decisions.

HERTFORDSHIRE COUNTY COUNCIL

Agenda Item No.

7

PENSIONS COMMITTEE
WEDNESDAY, 28 FEBRUARY 2018 AT 10:00AM

INTRODUCTION TO SECURITIES LENDING

Author: Jessica Hynes, Mercer

INTRODUCTION TO SECURITIES LENDING

HERTFORDSHIRE COUNTY COUNCIL

FEBRUARY 2018

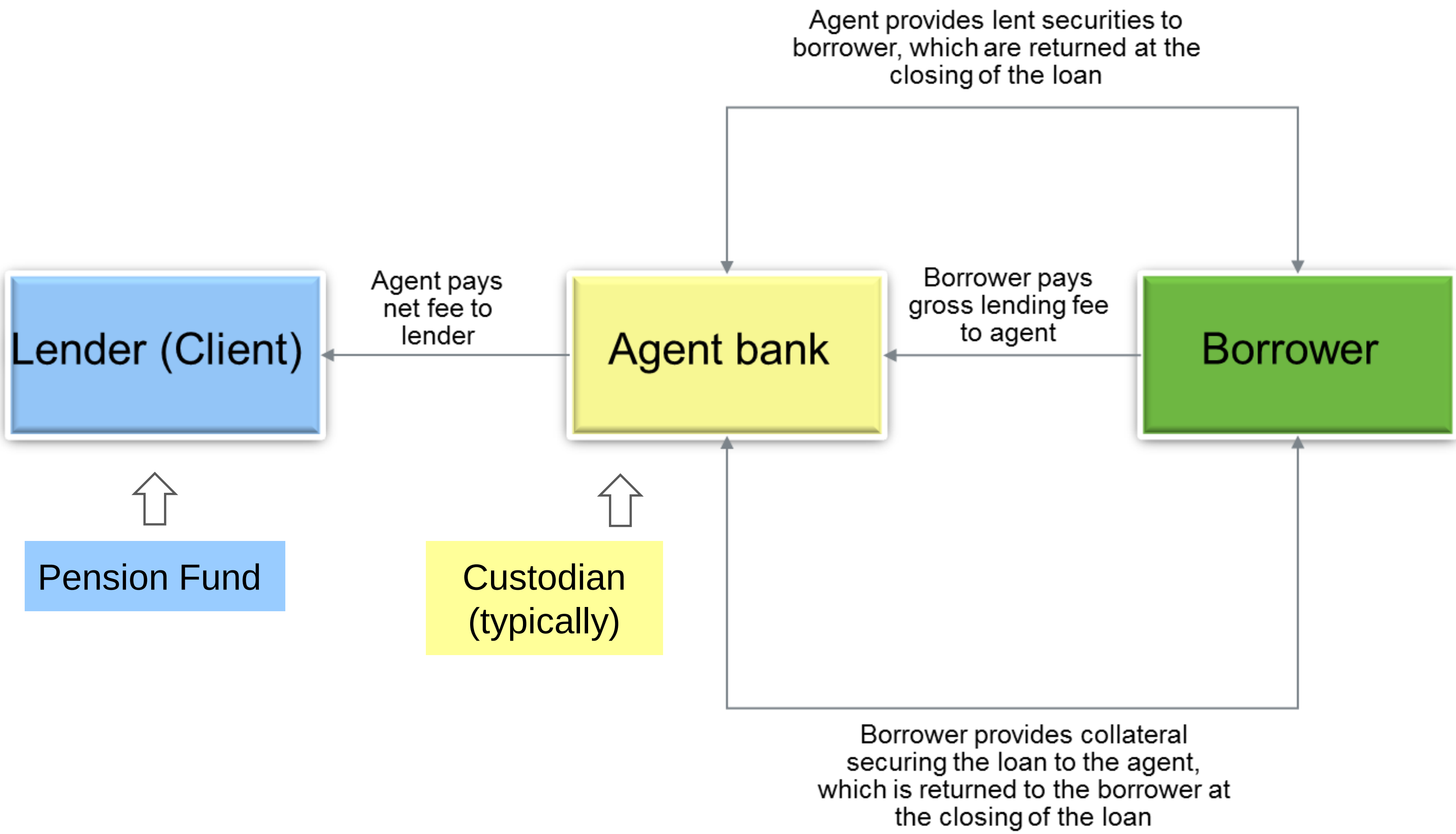
Jessica Hynes

London - Tower Place

WHAT IS SECURITIES LENDING?

- Securities lending is the act of loaning an equity, bond or other security to another investor via a brokerage firm.
  - The borrower provides collateral - in the form of highly liquid securities - against what they have borrowed (in case they don't return the loaned security).
  - The terms of the loan are set out in a securities lending agreement which details the term of the loan, the lenders fee and the nature of the collateral.
- Securities Lending is a permitted and regulated activity in most of the world's major securities markets but can only be conducted for specific purposes.
- When a security is loaned, the **title of the security** transfers to the borrower. This means that the borrower has the advantages of becoming the full legal *and* beneficial owner of the security, without purchasing it.
- The borrower **receives all coupon and/or dividend payments, and all voting rights.** The dividends or coupons must be passed back to the lender in the form of a "manufactured dividend".

THE MECHANICS OF SECURITIES LENDING



WHO ARE THE BORROWERS?

Who borrows equities?

- Asset managers needing to cover unexpected trade failures
- Hedge funds who wish to "short the market" will borrow equities and sell them immediately.
  - When/if the value of the security declines, then the borrower of the "short" position then will decide to buy the security back at a lower price and close the loan, whilst realising the gain.
- If the price goes up, the hedge fund may close its position by buying back the asset at the higher price and realising the loss, and returning the loan.

Who borrows fixed income?

- Banks and other financial institutions looking for high-quality liquid assets (HQLA) for balance sheet support, to lower their Risk Weighted Asset (RWA) ratios for regulatory and capital charges
- Collateral transformation trades to support OTC (over the counter) clearing collateral requirements for central counterparties
- Pension funds looking to hedge the interest rate and inflation sensitivity of their liabilities as part of "liability driven investment" strategies

FIXED INCOME LENDING EXPLAINED

- Pension funds often hold large, stable positions of High Quality Liquid Assets (HQLA) such as UK Gilts or US Treasuries. Prior to the financial crisis, there was no demand to borrow this asset class. However, with new Basel III regulations on collateralisation and capital quality, HQLA is very attractive for lending. There are two main drivers:
  1. **Collateral upgrade:** OTC derivatives must now be collateralised in a Central Counterparty (CCP) clearing house; only HQLA is accepted. Investors who do not hold HQLA then must trade lower quality assets, such as corporate bonds or equities, against HQLA so that they can support their LDI strategies that require OTC swaps.
  2. **Term Lending**: Banks are required to maintain a high quality of risk weighted assets (RWA) to achieve regulatory risk ratio targets under Basel III regulations. The assets must be held for over 90 days in order to be considered long-term holdings for this purpose. Therefore they will borrow HQLA on a 95 day "evergreen" rolling term in order to improve their RWA rating and lower their capital charges. This attracts a much higher fee but locks up the position for 90 days or more.

HOW DOES SECURITIES LENDING MAKE MONEY?

The asset owner (pension fund) earns **fees on the value of its loans**, based on the type of asset and its desirability, for example up to:

- 5 basis points (bps) on general collateral trades
- 20 bps on term lending of fixed income
- 50 bps on certain emerging markets equities
- 100+ bps on "specials" that are in demand and hard to find

The agent bank generally takes a gross fee from the borrower, then **splits the fee** with the lender by an agreed percentage:

- 50-50: only seen in internal bank pooled funds, quite rare
- 60-40: typically seen in pooled funds
- 70-30: more usual for segregated lenders and some pooled funds
- 80-20: for larger segregated accounts of $1+ billion of lendable assets
- 90-10: for the very largest accounts with $25+ billion

As a larger pool of assets, ACCESS should be able to negotiate strong securities lending terms

RISK MANAGEMENT

What are the Risks of Lending?	How Lending Risks are Mitigated
Borrower credit risk	**Counterparty Management**
Securities "lending" involves a transfer of legal title to the borrower's name. The lender therefore has a credit exposure to the borrower.	The agent will have rigorous counterparty credit management. Lenders can select approved counterparties, set credit and concentration limits to spread risk.
Collateral Quality	**Collateral Management**
All loans are collateralised. Collateral selection is a critical part of the lending programme. Whether to accept cash, fixed income or equities, and the quality of the collateral, will determine the attractiveness of the lender to the borrower. There will be pressure to accept lower quality collateral in order to increase revenues.	The lender (pension fund) has the right to determine the quality of the collateral that is acceptable. The lender must seek a balance between collateral quality demanded and the attractiveness of the portfolio to potential borrowers. For example, high-quality Gilts will not be attractive to borrowers if high-quality fixed income is demanded as collateral.
Borrower default	**Over-Collateralisation**
A borrower becomes insolvent and/or is unable to return a loan on demand. This is relatively common.	Borrowers pledge collateral which has a "hair-cut" that exceeds the value of the securities on loan, typically by 102 to 105%. Lenders can raise this hair-cut for lower quality collateral, such as equities, to 108% or more. Upon default, the agent will sell the collateral and re-purchase the loaned securities in the market to make the lender whole.
Collateral Shortfall	**Indemnification**
If the borrower defaults, AND the collateral is insufficient to re-purchase the securities on loan in the market, then there will be a shortfall. This is relatively uncommon, and usually happens with lower-quality illiquid collateral that cannot be sold quickly.	Many agents, and all custodian banks as agent lenders, offer an indemnification against collateral insufficiency, and will pay the difference between the loan and collateral value in order to make the lender whole. They will mark-to-market the collateral on a daily basis in order to ensure positions are over-collateralised by the agreed haircut to mitigate this occurring.
Agent default	**Creditor**
Worst Case: The borrower defaults, AND the collateral is insufficient to repurchase the loan, AND the agent (custodian bank) becomes insolvent, all on the same day. This has never happened: even with Lehman Brothers' default, all the positions were closed within 72 hours.	When engaged in an agency agreement there is no credit exposure to the securities lending agent per se. The only exposure would be in the marginal difference between the value of the loan and the shortfall that is not covered. The lender would then become a creditor to the agent.

WHAT WENT WRONG IN THE FINANCIAL CRISIS?

- Mis-management of cash collateral was the source of securities lending losses in the financial crisis of 2008/2009.
  - As a result cash collateral is not commonly used in Europe (although it remains common in USA).
  - European lenders primarily use a basket of equities or gilts as collateral due to the liquid nature of these assets.
- Where cash collateral is used, it is invested into a Liquidity Fund where the manager invests the cash collateral in a wide variety of fixed income securities e.g. overnight, 30 to 90 day time deposits and commercial paper.
- Longer duration Asset Backed Securities (ABS) with higher returns may be used to improve returns. In the crash of 2009, very long dated (multi-year) ABS were held and when lenders went to terminate their programs, the borrowers returned the securities and demanded their cash collateral back.
  - The collateral was then found to be held in illiquid ABS and in that case could not be liquidated. The lenders were left with large un-indemnified losses as they were obligated to return cash they did not have.

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The value of your investments can go down as well as up, and you may not get back the amount you have invested. Investments denominated in a foreign currency will fluctuate with the value of the currency. Certain investments carry additional risks that should be considered before choosing an investment manager or making an investment decision.

MERCER

MAKE TOMORROW, TODAY