

ABERDEEN CITY COUNCIL

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|---------------------------|---|
| COMMITTEE | Pensions Committee |
| DATE | 22 March 2024 |
| EXEMPT | No |
| CONFIDENTIAL | No |
| REPORT TITLE | Internal Audit Report AC2410 – Pensions Investment Strategy |
| REPORT NUMBER | IA/AC2410 |
| DIRECTOR | N/A |
| REPORT AUTHOR | Jamie Dale |
| TERMS OF REFERENCE | 2.2 |

1. PURPOSE OF REPORT

- 1.1 The purpose of this report is to present the planned Internal Audit report on the Pensions Investment Strategy.

2. RECOMMENDATION

- 2.1 It is recommended that the Committee review, discuss and comment on the issues raised within this report and the attached appendix.

3. CURRENT SITUATION

- 3.1 Internal Audit has completed the attached report which relates to an audit of the Pensions Investment Strategy.

4. FINANCIAL IMPLICATIONS

- 4.1 There are no direct financial implications arising from the recommendations of this report.

5. LEGAL IMPLICATIONS

- 5.1 There are no direct legal implications arising from the recommendations of this report.

6. ENVIRONMENTAL IMPLICATIONS

- 6.1 There are no direct environmental implications arising from the recommendations of this report.

7. RISK

7.1 The Internal Audit process considers risks involved in the areas subject to review. Any risk implications identified through the Internal Audit process are detailed in the resultant Internal Audit reports. Recommendations, consistent with the Council’s Risk Appetite Statement, are made to address the identified risks and Internal Audit follows up progress with implementing those that are agreed with management. Those not implemented by their agreed due date are detailed in the attached appendices.

8. OUTCOMES

8.1 There are no direct impacts, as a result of this report, in relation to the Council Delivery Plan, or the Local Outcome Improvement Plan Themes of Prosperous Economy, People or Place.

8.2 However, Internal Audit plays a key role in providing assurance over, and helping to improve, the Council’s framework of governance, risk management and control. These arrangements, put in place by the Council, help ensure that the Council achieves its strategic objectives in a well-managed and controlled environment.

9. IMPACT ASSESSMENTS

| Assessment | Outcome |
|----------------------------------|---|
| Impact Assessment | An assessment is not required because the reason for this report is for Committee to review, discuss and comment on the outcome of an internal audit. As a result, there will be no differential impact, as a result of the proposals in this report, on people with protected characteristics. |
| Privacy Impact Assessment | Not required |

10. BACKGROUND PAPERS

10.1 There are no relevant background papers related directly to this report.

11. APPENDICES

11.1 Internal Audit report AC2410 – Pension Fund Investment Strategy

12. REPORT AUTHOR CONTACT DETAILS

| | |
|----------------------|--|
| Name | Jamie Dale |
| Title | Chief Internal Auditor |
| Email Address | Jamie.Dale@aberdeenshire.gov.uk |
| Tel | (01467) 530 988 |



Internal Audit

Assurance Review of the Pensions Investment Strategy

Status: Final

Date: 1 February 2024

Risk Level: Corporate

Report No: AC2410

Assurance Year: 2023/24

| Net Risk Rating | Description | Assurance Assessment |
|-----------------|---|----------------------|
| Moderate | There is a generally sound system of governance, risk management and control in place. Some issues, non-compliance or scope for improvement were identified, which may put at risk the achievement of objectives in the area audited. | Reasonable |

| Report Tracking | Planned Date | Actual Date |
|------------------------|--------------|-------------|
| Scope issued | 26-Sep-23 | 26-Sep-23 |
| Scope agreed | 29-Sep-23 | 29-Sep-23 |
| Fieldwork commenced | 02-Oct-23 | 02-Oct-23 |
| Fieldwork completed | 03-Nov-23 | 18-Dec-23 |
| Draft report issued | 24-Nov-23 | 20-Dec-23 |
| Process owner response | 15-Dec-23 | 16-Jan-24 |
| Director response | 22-Dec-23 | 29-Jan-24 |
| Final report issued | 29-Dec-23 | 01-Feb-24 |
| Pensions Committee | 22-Mar-24 | |

| Distribution | |
|---------------|---|
| Document type | Assurance Report |
| Director | Steven Whyte, Director – Resources |
| Process Owner | Laura Colliss, Pensions Manager |
| Stakeholders | Jonathan Belford, Chief Officer – Finance |
| | Graham Buntain, Investment Manager |
| | Mairi Suttie, Governance and Communications Manager |
| | Vikki Cuthbert, Interim Chief Officer – Governance* |
| *Final Only | External Audit* |
| Lead auditor | Farai Magodo, Auditor |

1 Introduction

1.1 Area subject to review

The North East Scotland Pension Fund (NESPF) is administered by Aberdeen City Council and was valued at £5.7b at the end of the 2022/23 financial year with nearly 77,000 members. The Aberdeen City Council Transport Fund was previously separate to NESPF but was merged with NESPF on 1 April 2022.

The Fund is built up from contributions from both employees and employing bodies, together with interest, dividends, and rent from investments, out of which pensions and other benefits are paid. Employee contributions are fixed by statute, while employer contributions are assessed every three years by an independent actuary to determine the level of contributions necessary by employing bodies to ensure that the Fund can meet future benefits as they fall due.

To maintain, and where appropriate increase, the value of the Fund's assets to meet future liabilities as they fall due, and maintain the level of contributions appropriately, the Fund has set an Investment Strategy. This sets out a strategic portfolio allocation (between different classes or types of assets e.g., equities, bonds, credit, infrastructure) that each investment decision should aim to bring the Fund closer to achieving.

The Fund employs an internal Investment Management Team, at a cost of around £232k per annum, and uses external Investment Fund Managers, expenses for the services and performance of which currently amount to around £18m per annum. Fees vary depending on the type of investment, and performance as measured by the size and growth of assets allocated to a manager as compared with relevant benchmarks. An Investment Management Consultant has been appointed, and fees are payable where consultants are engaged to provide advice or conduct research.

1.2 Rationale for review

The objective of this audit is to provide assurance over compliance with the Pension Fund investment strategy, and the adequacy of controls over management of investments.

This area was last reviewed in September 2020. A recommendation was made to address a major weakness relating investment decision supporting documentation. In addition, recommendations were made to enhance performance reporting and procedures.

This has been included in 2023/24 NESPF Internal Audit Plan due to the material value of investments and the reputational risk to the Fund should employees and pensioners suffer financially due to poor investment decisions.

1.3 How to use this report

This report has several sections and is designed for different stakeholders. The executive summary (section 2) is designed for senior staff and is cross referenced to the more detailed narrative in later sections (3 onwards) of the report should the reader require it. Section 3 contains the detailed narrative for risks and issues we identified in our work.

2 Executive Summary

2.1 Overall opinion

The full chart of net risk and assurance assessment definitions can be found in Appendix 1 – Assurance Scope and Terms. We have assessed the net risk (risk arising after controls and risk mitigation actions have been applied) as:

| Net Risk Rating | Description | Assurance Assessment |
|-----------------|---|----------------------|
| Moderate | There is a generally sound system of governance, risk management and control in place. Some issues, non-compliance or scope for improvement were identified, which may put at risk the achievement of objectives in the area audited. | Reasonable |

The organisational risk level at which this risk assessment applies is:

| Risk Level | Definition |
|------------|---|
| Corporate | This issue / risk level impacts the Fund as a whole. Mitigating actions should be taken at the Senior Leadership level. |

2.2 Assurance assessment

The level of net risk is assessed as **MODERATE**, with the control framework deemed to provide **REASONABLE** assurance over the Council's approach to the care management system.

Assurance was taken over the following specific aspects of governance, risk management and control:

- **Approved Investment Strategy** – The North East Scotland Pension Fund (the Fund) has an Investment Strategy that was last approved in March 2021 by the Pensions Committee. When developing the strategy, consideration was given to the most recent actuarial valuation at that time (103% funding position), the Fund's funding strategy statement objectives (e.g. long term 100% solvency), and external investment advice.
- **Governance Arrangements** – Investment governance arrangements are clearly set out in the Council's scheme of governance and the Fund's governance policy. The Chief Officer – Finance is also supported by the Fund's Pensions Manager and Investment Manager, when making investment decisions. In addition, relevant policies and guidance are published providing a framework of control for investment decisions, including the Fund's investment policy; statement of investment principles; and conflicts of interest policy, the latter evidenced by the Fund's conflicts register for members and officers.
- **Fund Managers** – The fund managers used by the Fund are all authorised by the Financial Conduct Authority. In addition, annual audited internal controls compliance reports for all fund managers are monitored by the Investment Manager to provide assurance over the fund managers' investment management and reporting arrangements.
- **Regular Performance Monitoring** – Regular performance monitoring is in place. Quarterly performance reports are provided by the fund managers and a consolidated report validating performance across all fund managers is provided on the same frequency by the Fund's custodian. In addition, quarterly meetings take place with the fund managers to discuss reported performance, while fortnightly meetings take place with the custodian to monitor progress resolving any fund manager performance issues. Asset and investment manager performance is a quarterly Pensions Committee meeting standing item.
- **ESG Reporting** – The Fund has a fiduciary duty to consider environmental, social, and corporate governance (ESG) as an embedded principle of risk and return assessment in determining its investment portfolio and to ensure fund managers are doing likewise. Engagement with fund managers on ESG matters was evident.

However, the review identified some areas of weakness where enhancements could be made to strengthen the framework of control, specifically:

-
- **Asset Class Strategic Allocation** – The Investment strategy agreed in March 2021 is not being achieved with growth assets making up 64.6% against a target of 55% (+/-5%) and income / protection assets at 35.4% compared to a target of 45% (+/-5%) as at 15 December 2023 (see appendix 3). In addition, performance reporting to Pensions Committee lacks clarification on planned actions to rebalance the fund in line with the strategy and what is preventing action been taken. In the absence of clear performance reporting covering decisions to postpone rebalancing, there is a risk of overexposure to growth assets and of recent gains not being secured for scheme members as planned.
 - **Investment and Disinvestment Decision Making** – Aspects of investment decision making and the funding of those investments are not clearly supported. There are no minutes / action notes of internal operational meetings where decisions are made to hold off rebalancing the Fund in line with the strategic allocation. Also, once the decision has been made to make an investment it is not clear how the value of the investment is determined, when it is appropriate to seek external investment advice and the basis for disinvestment decisions to fund a given investment. These issues increase the risk Best Value will not be achieved.
 - **Board and Committee Members' Training** – Mandatory training has not been completed as required by all Pension Board and Pensions Committee members. This increases the risk Board members will lack the necessary knowledge and understanding to identify and challenge breaches of pensions legislation and regulations and Pensions Committee members will be insufficiently informed to adequately scrutinise investment decisions in the interests of the Fund. The Pensions Manager has already agreed to an External Audit recommendation to help address this by promoting and encouraging internal and external training. To avoid duplication of effort no Internal Audit recommendation has been made, however this will be monitored through updates to Committee on implementation of the External Audit action.

Recommendations have been made to address the above risks, including enhancing asset and investment performance reporting to cover rebalancing planned actions and reason for inaction; formalising operational investment monitoring outcomes; and documenting investment value and advice considerations and the basis for disinvestment decisions.

2.3 Severe or major issues / risks

No severe or major issues/risk were identified as part of this review.

2.4 Management response

We thank Internal Audit for their work in this area, accept their findings and will take forward the agreed actions.

3 Issues / Risks, Recommendations, and Management Response

3.1 Issues / Risks, recommendations, and management response

| Ref | Description | Risk Rating | Moderate |
|---|---|------------------|-----------------|
| 1.1 | <p>Asset Class Strategic Allocation – Strategic goals should be specific, measurable, attainable, responsible, and time-bound (SMART) to be meaningful and to ensure they are achieved as anticipated.</p> <p>The Fund's investment strategy describes the '<i>strategic allocation</i>' desired asset class percentage split, which was agreed in March 2021, and as at 15 December 2023 this is not being achieved (see appendix 3). Growth assets are making up 64.6% against a target of 55% (+/-5%), while income/protection assets are at 35.4% compared to a target of 45% (+/-5%).</p> <p>The Pensions Committee performance reporting covers the actual compared to strategic allocation asset split and separately investment decisions are reported to Pensions Committee with commentary on the basis of those decisions, including with respect to rebalancing the fund (within the Investment Strategy paper). However, commentary is absent from asset and investment quarterly performance reports to Pensions Committee describing reasons for postponing fund rebalancing in line with the strategic allocation and when it is anticipated conditions will be suitable to do so in future.</p> <p>Whilst Pensions Committee members have the opportunity to receive verbal clarification on these matters when reviewing regular asset and investment performance reports, the absence of documented rebalancing plans and reasons for postponing rebalancing actions as part of performance reporting, increases the risk of overexposure to growth assets and of recent gains not being secured for employees / pensioners as planned.</p> | | |
| IA Recommended Mitigating Actions | | | |
| Asset and investment performance reporting to Pensions Committee should adequately cover planned actions to rebalance the Fund in line with the investment strategy and where appropriate reasons for action not being taken. | | | |
| Management Actions to Address Issues/Risks | | | |
| <i>All rebalancing decisions are approved by the CO Finance and an investment strategy update report is provided to Committee. An additional note to the Asset and Investment performance report will be provided to either refer committee to the Investment Strategy update report or to state no changes have been made during the reporting period, which will be highlighted, discussed and minuted.</i> | | | |
| Risk Agreed | | Person(s) | Due Date |
| Yes | | Pension Manager | March 2024 |

| Ref | Description | Risk Rating | Moderate |
|-----|---|-------------|----------|
| 1.2 | <p>Investment and Disinvestment Decision Making – The Council's Scheme of Governance delegates to the Chief Officer – Finance the power:</p> <p><i>"To implement investment arrangements for the North East Scotland Pension Fund in accordance with the Local Government Pension Regulations, including sourcing and appointment of investment fund managers within the approved strategy".</i></p> | | |

| Ref | Description | Risk Rating | Moderate |
|-----|--|-------------|----------|
| | <p>This means the Chief Officer – Finance has delegated authority to determine the approach to achieving the strategic allocation of Fund assets, which are currently overweight in terms of growth assets.</p> <p><u>Investment Timing</u></p> <p>Whilst the Service advised that regular tactical meetings take place between the Investment Manager, Pensions Manager and Chief Officer – Finance to discuss reallocation of funds, action notes or minutes of these meetings are not maintained, meaning it is not clear how it is determined when the timing is and is not right to reallocate funds between fund managers in accordance with the strategy. Where reasons to not invest in line with the strategy are not captured, there is a greater risk necessary rebalancing actions will not be taken and achieved gains not secured in line with the investment strategy.</p> <p><u>Investment Documentation</u></p> <p>Investment decision-making supporting documentation has improved due to a recommendation to address this in the last Internal Audit of this area. Documentation refers to the Fund's desired strategic asset allocation, the basis of shortlisted options and options appraisal and there are clear details of review and approval.</p> <p>However, documented explanation for the value chosen could be improved, based on the most recent decision to commit £300m to an infrastructure investment, since it was not clear how the value was determined and not for example a higher value, with additional strategic allocation capacity available for infrastructure assets, or indeed why a lower value was not chosen to enable greater diversification of infrastructure investments. In addition, external investment advice was not taken for this significant investment and the approval form lacked explanation as to why this was the case.</p> <p><u>Disinvestment Documentation</u></p> <p>Also, whilst the cash management policy states the new investment opportunity document will provide details of how the opportunity will be funded and that any changes will be reported, this was not the case for the recent £300m infrastructure investment requiring two payments of £150m i.e. there was no supporting documentation explaining the options appraisal for disinvestment decisions to determine what amount(s) should be withdrawn from which fund manager(s) based on expected performance and related risks.</p> <p>Where investment and disinvestment decisions are not adequately supported by documentation explaining the basis of those decisions, there is a greater risk Best Value will not be achieved for scheme members.</p> | | |
| | IA Recommended Mitigating Actions | | |
| | <p>a) Outputs of internal investment tactical meetings should be captured.</p> <p>b) Material disinvestment decisions should be supported by options appraisal.</p> <p>c) Investment approval documentation should cover basis of investment value and investment advice considerations</p> | | |
| | Management Actions to Address Issues/Risks | | |
| | <p>a) <i>Investment monitoring arrangements are in place, quarterly reports provided by Managers, quarterly/AGM meetings with Managers are captured. Management will review the current outputs of internal operational investment monitoring (i.e. investment tactical meetings) and ensure they are as comprehensive as possible and documented as appropriate, including reasons for not rebalancing in line with the investment strategy..</i></p> <p>b) <i>Operational assets management will be documented and decisions evidenced.</i></p> | | |

| Ref | Description | Risk Rating | Moderate |
|-----|---|------------------|--|
| | <i>c) Investment approval documentation, includes basis of investment and value. Officers will expand on investment advice consideration.</i> | | |
| | Risk Agreed | Person(s) | Due Date |
| | a) Yes b) Yes c) Yes | Pension Manager | a) February 2024 b) February 2024 c) February 2024 |

4 Appendix 1 – Assurance Terms and Rating Scales

4.1 Overall report level and net risk rating definitions

The following levels and ratings will be used to assess the risk in this report:

| Risk level | Definition |
|------------------------------|---|
| Corporate | This issue / risk level impacts the Fund as a whole. Mitigating actions should be taken at the Senior Leadership level. |
| Function | This issue / risk level has implications at the functional level and the potential to impact across a range of services. They could be mitigated through the redeployment of resources or a change of policy within a given function. |
| Cluster | This issue / risk level impacts a particular Service or Cluster. Mitigating actions should be implemented by the responsible Chief Officer. |
| Programme and Project | This issue / risk level impacts the programme or project that has been reviewed. Mitigating actions should be taken at the level of the programme or project concerned. |

| Net risk rating | Description | Assurance assessment |
|-----------------|--|----------------------|
| Minor | A sound system of governance, risk management and control exists, with internal controls operating effectively and being consistently applied to support the achievement of objectives in the area audited. | Substantial |
| Moderate | There is a generally sound system of governance, risk management and control in place. Some issues, non-compliance or scope for improvement were identified, which may put at risk the achievement of objectives in the area audited. | Reasonable |
| Major | Significant gaps, weaknesses or non-compliance were identified. Improvement is required to the system of governance, risk management and control to effectively manage risks to the achievement of objectives in the area audited. | Limited |
| Severe | Immediate action is required to address fundamental gaps, weaknesses or non-compliance identified. The system of governance, risk management and control is inadequate to effectively manage risks to the achievement of objectives in the area audited. | Minimal |

| Individual issue / risk | Definitions |
|-------------------------|--|
| Minor | Although the element of internal control is satisfactory there is scope for improvement. Addressing this issue is considered desirable and should result in enhanced control or better value for money. Action should be taken within a 12 month period. |
| Moderate | An element of control is missing or only partial in nature. The existence of the weakness identified has an impact on the audited area's adequacy and effectiveness. Action should be taken within a six month period. |
| Major | The absence of, or failure to comply with, an appropriate internal control, such as those described in the Scheme of Governance. This could result in, for example, a material financial loss, a breach of legislative requirements or reputational damage to the Fund. Action should be taken within three months. |
| Severe | This is an issue / risk that is likely to significantly affect the achievement of one or many of the Fund's objectives or could impact the effectiveness or efficiency of the Fund's activities or processes. Examples include a material recurring breach of legislative requirements or actions that will likely result in a material financial loss or significant reputational damage to the Fund. Action is considered imperative to ensure that the Fund is not exposed to severe risks and should be taken immediately. |

5 Appendix 2 – Assurance review scoping document

5.1 Area subject to review

The North East Scotland Pension Fund (NESPF) is administered by Aberdeen City Council and was valued at £5.7b at the end of the 2022/23 financial year with nearly 77,000 members. The Aberdeen City Council Transport Fund was previously separate to NESPF but was merged with NESPF on 1 April 2022.

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The Fund employs an internal Investment Management Team, at a cost of around £232k per annum, and uses external Investment Fund Managers, expenses for the services and performance of which currently amount to around £18m per annum. Fees vary depending on the type of investment, and performance as measured by the size and growth of assets allocated to a manager as compared with relevant benchmarks. An Investment Management Consultant has been appointed, and fees are payable where consultants are engaged to provide advice or conduct research.

5.2 Rationale for review

The objective of this audit is to provide assurance over compliance with the Pension Fund Investment Strategy, and the adequacy of controls over management of investments.

This area was last reviewed in September 2020. A recommendation was made to address a major weakness relating investment decision supporting documentation. In addition, recommendations were made to enhance performance reporting and procedures.

This has been included in 2023/24 NESPF Internal Audit Plan due to the material value of investments and the reputational risk to the Fund should employees and pensioners suffer financially due to poor investment decisions.

5.3 Scope and risk level of review

This review will offer the following judgements:

- An overall **net risk** rating at the Corporate
- Individual **net risk** ratings for findings.

5.3.1 Detailed scope areas

As a risk-based review this scope is not limited by the specific areas of activity listed below. Where related and other issues / risks are identified in the undertaking of this review these will be reported, as considered appropriate by IA, within the resulting report.

The specific areas to be covered by this review are:

- Investment Strategy, Procedures and Guidance
- Investment Practice
- Performance Monitoring
- Performance Reporting

It is not the intention of this audit to review or assess the actual Investment Strategy, instead to provide assurance around it.

5.4 Methodology

This review will be undertaken through interviews with key staff involved in the process(es) under review and analysis and review of supporting data, documentation, and paperwork. To support our work, we will review relevant legislation, codes of practice, policies, procedures, and guidance.

5.5 IA outputs

The IA outputs from this review will be:

- A risk-based report with the results of the review, to be shared with the following:
 - Fund Key Contacts (see 1.7 below)
 - Audit Committee (final only)
 - External Audit (final only)

5.6 IA staff

The IA staff assigned to this review are:

- Farai Magodo, Auditor (**audit lead**)
- Andy Johnston, Audit Team Manager
- Jamie Dale, Chief Internal Auditor (**oversight only**)

5.7 Fund key contacts

The key contacts for this review across the Fund are:

- Steven Whyte, Director - Resources
- Jonathan Belford, Chief Officer - Finance
- Laura Colliss, Pensions Manager (**process owner**)

5.8 Delivery plan and milestones

The key delivery plan and milestones are:

| Milestone | Planned date |
|------------------------|--------------|
| Scope issued | 26-Sep-23 |
| Scope agreed | 29-Sep-23 |
| Fieldwork commences | 02-Oct-23 |
| Fieldwork completed | 03-Nov-23 |
| Draft report issued | 24-Nov-23 |
| Process owner response | 15-Dec-23 |
| Director response | 22-Dec-23 |
| Final report issued | 29-Dec-23 |

6 Appendix 3 – Strategic and Actual Allocation of Fund Assets

| Asset Class | Strategic Allocation (%) | Q3 2023 Actual (%) | Q3 Strategic Allocation (£'m) | Q3 2023 Actual (£'m) |
|----------------------------------|--------------------------|--------------------|-------------------------------|----------------------|
| Global Equities | 50.0% | 57.1% | 2,774.9 | 3,170.0 |
| Private Equity | 5.0% | 7.5% | 277.49 | 416.1 |
| Total Growth | 55.0(+/-5)% | 64.6% | 3,052.39 (+/-277.5) | 3,586.1 |
| Bonds / Credit | 22.5% | 16.8% | 1,248.7 | 932.6 |
| Direct Property | 10.0% | 8.3% | 555.0 | 462.1 |
| Infrastructure | 10.0% | 7.5% | 555.0 | 413.5 |
| Other (Cash) | 2.5% | 2.8% | 138.7 | 155.5 |
| Total Income / Protection | 45.0(+/-5)% | 35.4% | 2,497.4 (+/-277.5) | 1,963.7 |
| Total | 100.0% | 100.0% | 5,549.8 | 5,549.8 |