



Internal Audit Report

North East Scotland Pension Fund

**Investment Strategy &
Investment Performance Management**

Issued to:

Richard Ellis, Director of Corporate Governance
Steven Whyte, Head of Finance
Laura Colliss, Pensions Manager
Anne MacDonald, Audit Scotland

EXECUTIVE SUMMARY

The North East Scotland Pension Fund (NESPF) and the Aberdeen City Council Transport Fund (ACCTF) are administered by Aberdeen City Council in accordance with Local Government Pension Scheme regulations.

The ACCTF which has a market value of around £90 million closed to new members in 1994, and has only 78 active (or paying) members, pension liabilities for around 650 others and is subject to a De-Risking Strategy. This aims to strengthen the Transport Fund's funding position without increasing expense for the employer(s) and to keep the costs of investment and risk as low as possible.

The main local government fund is valued at over £3.1 billion and provides pension arrangements for around 50 employers including Local Authorities, the Scottish Fire and Police Services, Further Education establishments and various charities and other bodies. It has around 24,000 active members, almost 18,000 deferred members (who don't currently pay into the scheme) and pays benefits to almost 18,000 pensioners and dependents each month.

The administering authority has delegated powers from the Council to the Pensions Committee and to senior Council officers, and the Fund is regulated by the Pensions Regulator. The NESPF Pensions Manager reports to Aberdeen City Council's Head of Finance and is currently responsible for 30 Pensions' staff. A restructure is currently underway, which will see staffing increase to 35 and the service operating in six distinct sections: Benefits, Accounting, Investment, Governance, Employer Relations and Information Technology. This structure was agreed in 2015.

Two audits of the Pension Fund were due to be undertaken in the 2015-16 Audit Plan: the first to review compliance with the Fund's Investment Strategy and the second to examine controls over the performance of Investment Fund Managers. After ascertaining the systems in place and discussion with the Service, Internal Audit concluded that due to the interrelationships between these areas both should be examined simultaneously and a single audit report produced.

In general, compliance with the Investment Strategy and controls over the performance of Fund Managers are adequate. Recommendations to improve how compliance and controls can be better evidenced have been made and actions agreed with the Service as follows:

The Service has agreed to improve consistency in how Fund Managers contracts, and fee structures are recorded, and has developed written procedures for checking and approving management and custodian fees. The Service has accepted the need to clarify how assurance will be obtained over Fund Managers governance arrangements before they are selected, as decisions have historically been made on an ad-hoc basis, and will seek Committee approval of an acceptable level of variance in asset valuations, on which fees are based.

Improvements have been recommended and agreed to the Service's quarterly performance monitoring reports to more clearly show management interpretation of the results and planned action, and include details of movements and fees in addition to opening and closing valuations.

Although a contracts register is held by the Service it is not being used to proactively manage tendering and contract review exercises in line with public procurement rules. The Service has stated that due to the nature and complexity of the Pension Fund, the Fund seeks to establish strategic partnerships with its advisors to ensure it delivers

an efficient and compliant Scheme, which in turn may conclude to longer term relationships, and it will provide an update to Committee in 2016.

The Council's Treasury Section carried out a number of transactional and investment activities on behalf of the Fund, and it is intended to expand this role in the future, however it is not currently documented in a Service Level Agreement. The Service will develop this.

The Council's Orders of Reference in respect of the Pensions Committee need to be updated to reflect changes to the governance structure in 2015. Revisions have been put forward by the Service for review by the Council.

Training for staff and councillors is not always consistently evidenced. The Service has agreed to implement processes to ensure this is captured and any gaps addressed.

1. INTRODUCTION

- 1.1 The North East Scotland Pension Fund (NESPF) and the Aberdeen City Council Transport Fund (ACCTF) are administered by Aberdeen City Council in accordance with Local Government Pension Scheme regulations.
- 1.2 The ACCTF which has a market value of around £90 million closed to new members in 1994, and has only 78 active (or paying) members, pension liabilities for around 650 others and is subject to a De-Risking Strategy. This aims to strengthen the Transport Fund's funding position without increasing expense for the employer(s) and to keep the costs of investment and risk as low as possible.
- 1.3 The main local government fund is valued at over £3.1 billion and provides pension arrangements for around 50 employers including Local Authorities, the Scottish Fire and Police Services, Further Education establishments and various charities and other bodies. It has around 24,000 active members, almost 18,000 deferred members (who don't currently pay into the scheme) and pays benefits to almost 18,000 pensioners and dependents each month.
- 1.4 The administering authority has delegated powers from the Council to the Pensions Committee and to senior Council officers, and the Fund is regulated by the Pensions Regulator. The NESPF Pensions Manager reports to Aberdeen City Council's Head of Finance and is currently responsible for 30 Pensions' staff. A restructure is currently underway, which will see staffing increase to 35 and the service operating in six distinct sections: Benefits, Accounting, Investment, Governance, Employer Relations and Information Technology. This structure was agreed in 2015.
- 1.5 Two audits of the Pension Fund were due to be undertaken in the 2015-16 Audit Plan: the first to review compliance with the Fund's Investment Strategy and the second to examine controls over the performance of Investment Fund Managers. After ascertaining the systems in place and discussion with the Service, Internal Audit concluded that due to the interrelationships between these areas both should be examined simultaneously and a single audit report produced.
- 1.6 The governance of both Funds is similar, therefore recommendations made in this report are applicable to the governance of both funds (hereafter referred to as 'the Fund'). Figures referred to in this report however, relate to the main Fund unless otherwise stated.
- 1.7 The factual accuracy of this report and action to be taken with regard to the recommendations made have been agreed with Steven Whyte, Head of Finance, and Laura Colliss, Pensions Manager.

2. FINDINGS AND RECOMMENDATIONS

2.1 Governance

2.1.1 Aberdeen City Council's Head of Finance is responsible for oversight of the North East of Scotland Pension Fund and reports to the Pensions Committee and the Pensions Board. These replaced the Joint Investment Advisory Committee and the Pensions Panel in 2015. Committee and Board members include representatives from Employers, Trade Unions and Councillors. The Committee has responsibility for monitoring operational and strategic performance and decisions, while the Board is in place to enhance governance and ensure that the Committee is aware of and complies with Pensions Legislation. The two bodies meet concurrently on a quarterly basis and attendance records show adequate representation.

2.1.2 The Council has Orders of Reference in place for the Pensions Committee, however these have not been updated to reflect governance structure changes fully, in that they still make reference to the Joint Investment Advisory Committee which was decommissioned. For avoidance of ambiguity over the Fund's governance structure, these Orders of Reference should be revised.

Recommendation

The Administering Authority should ensure that the Pensions Committee's Orders of Reference reflect its current remit.

Service Response / Action

Agreed. Revised Orders of Reference have been drafted and provided to Legal for review (5 April 2016).

Implementation Date

June 2016

Responsible Officer

Pensions Manager

Grading

Important within audited area

2.1.3 References to the former governance structure were also noted in the Investment Policy and Strategy documents, however these were set in advance of the Committee changes taking place. The Service advises that these will be revised when the 2016 strategy document is published.

2.1.4 The Pensions Act 2004 requires trustees to have knowledge and understanding of the law relating to pensions and trusts, and the principles relating to the funding of occupational schemes and the investment of scheme assets. Trustees are also required to be conversant with the scheme's policy documents.

2.1.5 The Pensions Manager arranges training for Pensions staff and for Committee and Board Members in order to ensure they are adequately equipped to administer the fund. In addition to its compliance role, the Pensions Regulator provides guidance for pension fund trustees and to those who manage the fund. It has an e-learning training 'toolkit' which can be used to train individuals and record learning progress.

2.1.6 Although there are no apparent training issues, the level of knowledge and understanding amongst staff and trustees in terms of fund management and investment is not currently evidenced. There may therefore be unidentified gaps in understanding and knowledge which could impact on fund governance and investment decisions.

2.1.7 The Service has stated that revising the staffing structure has provided opportunity to revise staff training policies so that they tie in to the Performance Review and Development process. This will enable training and development needs to be identified

and addressed, and recorded on Aberdeen City Council's HR System, thus increasing assurance over the competency of staff. A recommendation has been made to track progress being made in developing and improving this area.

Recommendation

The Administering Authority should ensure that staff training, development and competency is adequately evidenced.

Service Response / Action

Agreed. Staff training is an ongoing process and will be evidenced through individuals Performance Review and Development program and through the Pensions Fund internal training program that is currently being developed.

Implementation Date

March 2017

Responsible Officer

Pensions Manager

Grading

Important within audited area

- 2.1.8 Trustees are required by law to have an adequate level of understanding of pension scheme matters in order to ensure the proper running of the scheme and to fulfil their fiduciary duties. At present there is a lack of clear evidence to demonstrate that Trustees have the understanding and knowledge they require.

Recommendation

The Administering Authority should ensure that it can demonstrate that all trustees have the understanding and knowledge they require to ensure proper Fund investment and management.

Service Response / Action

Agreed. A continuous training program is provided to committee and board members providing them internal and external opportunities, including encouragement to take The Pensions Regulator 'toolkit'. A training report is taken to committee on a regular basis detailing opportunities and evidencing attendance. A full day's training was provided in March 2016 and further opportunities are being made available during 2016. An update will be provided to the Committee in June 2016.

Implementation Date

June 2016

Responsible Officer

Pensions Manager

Grading

Significant within audited area

- 2.1.9 The Fund's risk register was last reviewed in June 2015 and identifies the likelihood and impact of various risks including those which relate to funding and investment. The Register also provides an assessment of the risk control measures in place to mitigate these risks.

- 2.1.10 No significant control issues have been raised by the external auditor in the 2014/15 year-end report. Operating within the clear arrangements which are in place for delegated powers, authorisation and monitoring, governance over the Fund appears adequate.

2.2 Investment Strategy

- 2.2.1 The Fund's Investment Policy comprises two key strategies:

- The Funding Strategy ensures that the Fund is maintained so that future pension liabilities can be met, whilst keeping employer contribution rates constant, as far as possible, as required by regulations.

- The Statement of Investment Principles demonstrates the Pensions Committee's stance on investment diversity and risk and details the proportions of investment types which should be held to manage the trade-off between market risk exposure and investment return.

- 2.2.2 The impact of the strategies on the Fund is monitored on a quarterly basis and amended where it is deemed appropriate in light of the strength of employer covenants (employers' ability to pay their contributions), the performance of the Fund, and the triennial actuarial valuations.
- 2.2.3 The majority of Fund investment is undertaken by Investment Fund Management Companies (IFM's) who invest in markets and assets on behalf of NESPF in accordance with investment mandates which are set for them. Investment practice is governed by the Local Government Pension Scheme (Management and Investment of Funds) (Scotland) Regulations 2010. Market performance and IFM performance carry the two main risks to the Fund and both are therefore monitored in detail and reported on to the Committee on a quarterly basis.
- 2.2.4 The Service has various internal and external sources of both legal and investment advice which assist in setting the strategies and the investment mandates. The objective of the investment strategy is to maximise returns to the Pension Fund whilst reducing overall risk. The Fund is invested in a range of asset classes, including equities, bonds and property, in different countries, sectors and companies in order to spread the risk. The strategy detail should be clear, but it was noted that the investment spread published on the NESPF website (published November 2014) differs slightly from that which is currently being monitored and reported against:

Asset Class	Benchmark per Annual Report 2013/14	Benchmark per Annual Report 2014/15	Benchmark per Monitoring Sept. 2015	Benchmark per Website as at Feb. 2016
Equities	70% (+/- 5%)	70% (+/- 5%)	70% (+/- 5%)	70%
Bonds	10% (+/- 2%)	10% (+/- 2%)	10% (+/- 2%)	8%
Property	10% (+/- 2%)	10% (+/- 2%)	10% (+/- 2%)	10%
Alternative Asset (inc. Private Equities)	10%	10%	10%	12%
Cash	0%	0%	0%	0%

Recommendation

The Service should ensure that Investment Strategy documents always reflect current Pension Fund governance and investment arrangements and correspond to the Asset Class monitoring benchmarks within the quarterly monitoring.

Service Response / Action

Agreed. Information held on the Pension Fund Website will be amended.

Implementation Date

May 2016

Responsible Officer

Pensions Manager

Grading

Important within audited area

2.3 Fund Control and Investment

- 2.3.1 In order to ensure that the use of IFM's services does not expose the Fund to unnecessary risk, independent quality assurance reports (ISAE3402 Type II) are obtained by the Fund,

which is a requirement of the external auditor. These provide assurance over the internal controls operated by the IFM. Reports are retained as evidence of this assurance.

- 2.3.2 It was noted that rather than an independent report, one IFM had submitted a self-declaration which included detail of its internal control mechanisms. The Service has stated that given the level of investment (£4 million at September 2015) and the size of the Fund Management company itself, a self-declaration report was considered adequate and avoided additional costs. Whilst this may be reasonable, in order to demonstrate transparency and consistency of such decisions the Fund should set materiality levels or criteria for which independent assurance over IFM internal controls is required.

Recommendation

The Service should ensure justification for the level of independent assurance over IFM internal controls is documented.

Service Response / Action

Agreed. The provision of an internal controls report by an IFM will form part of our formal due diligence process and be included with our recommendations regarding appointment of new providers.

Implementation Date

May 2016

Responsible Officer

Pensions Manager

Grading

Important within audited area

- 2.3.3 Mandates are set for the Fund in order to restrict the investment scope of the IFM. Each mandate is underpinned by general terms and conditions and detail of the IFM's management fees. Market fluctuations will cause the actual value of the holding of each asset class to vary from the strategic benchmark, however the mandate(s) with each IFM require them to set and thereafter maintain the investment spread close to benchmark. Doing so maintains the asset mix and level of risk which has been agreed as appropriate for the Fund.
- 2.3.4 Mandates were reviewed and whilst no issues were found with mandate compliance (e.g. investing outwith the asset classes and markets permitted), many of the mandates are dated and have varied from time to time in respect of the general terms and conditions and the investment restrictions themselves. Some were initiated with IFM's several decades ago, but no listing of subsequent additions or revisions has been maintained.
- 2.3.5 In one instance it was not straightforward to determine whether a rebate from an IFM was at the appropriate rate. In the absence of clear and consistent records showing the changes and current mandates, the Service will have less assurance over the investment agreements and fee schedules in place, and may have difficulty in providing assurance that investments and payments are being made correctly.

Recommendation

The Service should maintain a chronological record of changes made to Investment Fund Manager mandates and general terms and conditions.

Service Response / Action

Agreed. This information will be included on the Pension Fund Contracts Register.

Implementation Date

September 2016

Responsible Officer

Pensions Manager

Grading

Significant within audited area

- 2.3.6 Although quarterly monitoring examines the performance of IFM's and the Fund's overall asset mix, there is no regular review of mandate documents. A regular check to ensure that the terms and conditions and fee structure are up to date and are still appropriate would be a further indicator of the control over investments and the Fund.

Recommendation

The Service should evidence periodic reviews of terms and conditions to provide assurance that Investment Fund Manager terms and conditions are up to date and appropriate.

Service Response / Action

Agreed. Periodic reviews of all mandates are undertaken, going forward they will be evidenced.

Implementation Date

May 2016

Responsible Officer

Pensions Manager

Grading

Important within audited area

- 2.3.7 In order to monitor and control fund manager activity, in addition to quarterly monitoring, the Fund uses the services of a global custodian. Any publicly listed asset for which an IFM is responsible is held by the custodian in a segregated nominee named account to enable them to trade and settle IFM transactions.
- 2.3.8 Direct Property is bought on behalf of the Pension Fund under a Power of Attorney by the Fund Manager in the Pension Fund's name.
- 2.3.9 All other non-listed assets (e.g. Private Equities) are held in the Pension Fund's name via a Limited Partnership Agreement with the Fund Managers.
- 2.3.10 All assets of the Pension Fund are accounted for by the custodian, reflecting the full market Value of the Pension Fund at any given time.
- 2.3.11 Reports of transactions declared by each IFM are received each month and are verified to custodian records.

2.4 Fees and Charges

- 2.4.1 Fund Manager fees are determined by the agreement in place with the Administering Authority. Fees may have several elements to them and be payable at different intervals. A sample of three fee payments was examined. All payments appear to have been made correctly, however the process for checking, processing and accounting for them is fairly complex and is not currently documented. Were key staff to leave, fee payments could be delayed while other staff are trained in the invoice payment process.

Recommendation

The Service should ensure that written guidance is prepared to demonstrate the procedure for checking, authorisation, processing and accounting for management and custodian fees.

Service Response / Action

Agreed. A procedure note has been completed.

Implementation Date

Implemented

Responsible Officer

Pensions Manager

Grading

Important within audited area

- 2.4.2 When the rates charged on invoices were reviewed, it was not possible to confirm all of the fee elements, particularly where rebates were concerned. Fee rates were not always clear in the agreements and are not held or recorded in a format which facilitates fee checking. Having a centralised record of Fund Manager rates would make it easier to demonstrate that fee payments are in line with agreed rates.

Recommendation

The Service should ensure that the rates charged by investment fund managers and the global custodian for all services are clearly and consistently documented.

Service Response / Action

Agreed. This information will be added to the Pension Fund Contracts Register.

Implementation Date

September 2016

Responsible Officer

Pensions Manager

Grading

Significant within audited area

- 2.4.3 Many fee elements are based on the asset valuation at the point of billing. Invoices are therefore supported by the Fund Managers' own report which shows the value of the Fund's assets under its control at the end of the billing period. To corroborate these figures, the custodian reconciles them with its own valuation of the same assets at the end of the billing period. The figures can vary as a result of differing measurement methods, timing differences or where some assets may be included / excluded from the custodian or Fund Managers' valuation.
- 2.4.4 Currently, provided a variance is no more than 10 basis points, the fund manager's valuation is accepted and fees are processed via the custodian's Workbench system. Payment is released only when the Pension Manager's approval is received in the system.
- 2.4.5 Where the figure varies by more than 10 basis points however, further investigation is required to determine the cause(s). Provided that the variance is less than 10 basis points after legitimate causes have been taken into account, the fund manager's valuation can be accepted.
- 2.4.6 The 10 basis points figure has not been officially set and appears to have no clear origin and in one instance a variance above this threshold, in favour of the Fund Manager, was accepted. There were no clear records that management had given consideration to and approval of the excess variance. Without an officially set fees variance tolerance threshold above which management approval is required to proceed with invoice payment, and evidence of compliance, there is less control and an increased risk of payments being made for fees based on inaccurate valuations.

Recommendation

The Service should ensure an appropriate asset valuation variance threshold for fee invoice verification purposes is approved by the Committee.

The Service should ensure that management approval is evidenced where variances exceed the asset valuation threshold.

Service Response / Action

Agreed.

The 10bps (0.10%) tolerance/variance is an industry standard and has been adopted by the Pension Fund over many years. This position will be confirmed to Committee.

Any situations that exceed this position will be reviewed by the Pensions Manager and sign off will be evidenced accordingly.

Implementation Date

June 2016

Responsible Officer

Pensions Manager

Grading

Significant within audited area

2.5 External Services

- 2.5.1 It was noted that the contract with the current custodian, the Bank of New York Mellon, has been in place since 2005. Although following a tender exercise the contract with a new custodian will commence during 2016/17, the same provider was used for over ten years without a competitive tender exercise being undertaken to demonstrate that proper procurement practice has been applied and best value demonstrated. The Service has a number of other contracts including those with the Fund's Legal and Investment Advisors for which competitive tendering exercises are overdue. Going forward, in order to ensure compliance with procurement regulations and the Council's Standing Orders, the Service should put controls in place to ensure contracts are retendered when necessary.

Recommendation

The Service should evidence a rolling procurement plan which ensures contracts are retendered when necessary.

Service Response / Action

Agreed. A report to Committee in March 2013 provides details on the appointment of Advisor and the timing of those appointments and reviews. BNY Mellon was appointed in 2005 and a review was commenced during 2008 however this was put on hold due to the financial crisis. The Pension Fund reviewed its Investment Consultant during 2015 with KPMG being appointed.

Due to the nature and complexity of the Pension Fund, the Fund seeks to establish strategic partnerships with its advisors to ensure we deliver an efficient and compliant Scheme, which in turn may conclude to longer term relationships.

An update of the March 2013 report will be presented to Committee during 2016, including planned dates for future procurement exercises.

Implementation Date

December 2016

Responsible Officer

Pensions Manager

Grading

Significant within audited area

- 2.5.2 While the investment banking of the Pension Fund is performed by the global custodian, operational transactions (e.g. receipt of contributions and payment of benefits) are undertaken by Aberdeen City Council's Treasury function. Given the Fund is a separate entity, it would be appropriate to have the arrangement formally recognised with reference to the work involved and the standards which are expected. At present this has not been done, although the Service anticipates having an agreement in place in 2016.
- 2.5.3 The Treasury Team also invests surplus cash from the Fund's bank accounts, in the Aberdeen City Council Loans Fund. The Service has expressed an intention to develop the Treasury section's involvement in Fund investment further, at which point more detailed protocols will be required.

Recommendation

The Service should ensure that appropriate agreements are in place which govern the banking and investment service provided to the Fund by Aberdeen City Council's Treasury Section.

Service Response / Action

Agreed. The Pension Fund will work with the Treasury Section to draft a Service Level Agreement that will include the current level of service and the additional services the Fund looks to implement.

Implementation Date

September 2016

Responsible Officer

Pensions Manager

Grading

Significant within audited area

2.6 Performance Monitoring

- 2.6.1 Quarterly reports of investment activity and Fund performance are presented to the Pensions Committee at each meeting. The figures within these are based on the global custodian's Fund Analysis and Performance report which provides a valuation of the Fund and an investment transaction report which is checked to the Fund Manager's own quarterly investment reports. In addition, a general overview is given of key markets which influence Fund performance, and a performance commentary is provided for each Investment Fund Manager.
- 2.6.2 The report shows whether investments are in line with the mandates (e.g. asset class mix) and performance benchmarks (e.g. 'outperform the market by 2% over 5 years') set for each IFM and generally present a long term view of investment performance. A long term view gives the IFM time to adjust their investment portfolio where the performance of any assets deteriorates in the interim. This way, market peaks and troughs do not skew the performance figures. Performance data is presented to the Pensions Committee on a Red, Amber, Green basis, enabling them to identify where targets are at risk of not being met.
- 2.6.3 The quarterly report gives an overall view of strategy compliance and fund manager performance, however it does not clearly state the Service's interpretation of the results, required action in response to targets not being met by IFM's (or a note that no action is considered necessary), or the implications of current performance for the Fund. In its current form the report generally leaves Trustees to form their own conclusions.
- 2.6.4 In addition, although the report provides details of the previous and current valuation of assets placed with each IFM this value is a combination of market valuation changes, asset transfers (which are not regularly undertaken), and fees. Without separating out this detail it will be difficult to put the performance of the IFM's in context.

Recommendation

The Service should ensure that quarterly reports provide adequate assurance over the current health of the pension fund, its performance and any action required.

The Service should separate out details of the different categories of fund movements.

Service Response / Action

Agreed.

The Asset and Investment Manager Performance Report is taken to Committee each quarter. Members are taken through the report discussing performance at Fund level

and at individual Fund Manager level. Any concerns are raised and discussed and evidenced through the minutes of the Committee meetings.

The report is an evolving document due to its content and changes within asset allocation and fund manager, and the Pension Fund seeks to incorporate all relevant information.

Additional narrative and split of fund movements will be included as recommended.

<u>Implementation Date</u>	<u>Responsible Officer</u>	<u>Grading</u>
June 2016	Pensions Manager	Significant within audited area

2.6.5 Despite a decrease in the Fund's market value from £3.171 billion at the 2014/15 year-end, to £3.003 billion in the September 2015 performance monitoring report, IFM performance has generally been above benchmark. Market performance has been the cause of the Fund's fall in value, with the impact of the fall in the price of crude oil, record low interest rates and inflation across the world, and uncertainties in the Eurozone and elsewhere all being contributors.

2.6.6 There is evidence that action is taken where performance is unsatisfactory. In December 2015 following many progress meetings with one IFM, the Pensions Committee was recommended to agree termination of several mandates which over the long term had continually underperformed. Such decisions are not taken lightly due to the costs involved in moving assets from one IFM to another. The report also recognised that the impact of the IFM's underperformance could jeopardise the de-risking of the Aberdeen City Council Transport Fund, and alternative proposals were being considered to avoid this.

2.6.7 Where assets have to be moved from an IFM this gives opportunity to rebalance the asset mix, proportions of which can change as markets and asset values fluctuate. This ensures that the Fund's investment is kept in line with the strategy and therefore in accordance with the risk exposure which has been agreed to by the Pensions Committee. The current asset mix and that for the previous financial year end are compared below to the benchmark target being monitored against:

Asset Class	Actual per Annual Report 2014/15	Benchmark Target per Monitoring (Sept. 2015)	Actual Asset Allocation per Monitoring (Sept. 2015)
Equities	82.2%*	70% (+/- 5%)	77.3%
Bonds	7.8%	10% (+/- 2%)	8.1%
Property	6.9%	10% (+/- 2%)	7.1%
Alternative Asset (inc. Private Equities)	*	10%	5.0%
Cash	3.1%	0%	2.5%

2.6.8 Asset holdings are broadly in line with the strategy, but more flexibility is being sought in order that the Pensions Manager and Head of Finance can react more quickly to shifts in the markets. Any request for additional flexibility will be put before the Committee for approval.

2.6.9 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. Presently the Fund is 'cash positive', in that income from contributions currently exceeds the value of benefits paid.

- 2.6.10 The Service identified however, that IFM's had been keeping increasing amounts of fund assets in the form of cash, on which there is little or no return. The target for cash holdings is 0%, although in practice this is not possible, e.g. cash balances are required in operational bank accounts to fund fees and payment of liabilities as they fall due.
- 2.6.11 Although the global custodian invests cash balances in the money markets overnight, the Service has recently sought to encourage fuller investment by the IFM's by introducing a cash holding restriction of 1.5% of the value of the portfolio they are responsible for. This should reduce cash holdings from the current holding of 2.5% (September 2015).
- 2.6.12 At September 2015, 1.5% of the overall fund equated to around £45 million. Given that this value will vary with the Fund's value, in addition to the percentage restriction, it might be beneficial to determine a financial limit of overall cash holdings, beyond which additional action should be taken, to prevent excessive amounts being held in cash. The Service has however stated that this would be impracticable since cash needs depend significantly on the payment of benefits due and flexibility for investment already committed to, particularly where private equity drawdowns are concerned. Foreign currency variances could also make it difficult to keep within a set monetary value.

2.7 Deficit Recovery Plan

- 2.7.1 The most recent triennial actuarial valuation was undertaken in March 2014 and indicated that the Fund would only meet 94% of its pension liabilities, were it to be wound up immediately. Deficits are not uncommon to pension schemes and NESPF's funding target is 100%. Accordingly, a Deficit Recovery Plan is in place which involves a programme of additional contributions tailored for each employer in the scheme. Advice on this plan and monitoring of its effectiveness is provided by the Fund Actuary, but the Fund will always be subject to market volatility and other risks which may inhibit the achievement and maintenance of the Funding Target.
- 2.7.2 According to the External Auditor's report, by the end of 2014/15 a roll-forward estimate put the funding position at 82%. This reduction was noted to be consistent with other Scottish local government pension schemes. Those responsible for managing and monitoring the Fund continue to take advice from the available sources, monitor performance and adjust strategies and plans as appropriate in order to safeguard the Fund and maintain it as a going concern. However, it has been decided that an interim valuation of the fund will be completed in 2016 in order to monitor the funding position more closely.

AUDITORS: D Hughes
C Harvey
P Smith

Appendix 1 – Grading of Recommendations

GRADE	DEFINITION
Major at a Corporate Level	The absence of, or failure to comply with, an appropriate internal control which could result in, for example, a material financial loss, or loss of reputation, to the Council.
Major at a Service Level	<p>The absence of, or failure to comply with, an appropriate internal control which could result in, for example, a material financial loss to the Service/area audited.</p> <p>Financial Regulations have been consistently breached.</p>
Significant within audited area	<p>Addressing this issue will enhance internal controls.</p> <p>An element of control is missing or only partial in nature.</p> <p>The existence of the weakness identified has an impact on a system's adequacy and effectiveness.</p> <p>Financial Regulations have been breached.</p>
Important within audited area	Although the element of internal control is satisfactory, a control weakness was identified, the existence of the weakness, taken independently or with other findings does not impair the overall system of internal control.