

Meeting of the

# PENSIONS COMMITTEE

---

Thursday, 9 June 2011 at 7.30 p.m.

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## A G E N D A

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### VENUE

M72, 7TH FLOOR, TOWN HALL, MULBERRY PLACE

**Members:**

**Chair: Councillor Anwar Khan**  
**Vice – Chair:**

**1 Vacant Post - Non-Voting Member**  
**(Trade Union)**  
**1 Vacant Post - Non-Voting Member**  
**(Admitted Body)**  
**Councillor Craig Aston**  
**Councillor Zenith Rahman**  
**2 Vacancies**  
**Councillor Abdal Ullah**  
**Councillor Ahmed Adam Omer**

**Deputies (if any):**

Councillor Tim Archer, (Designated Deputy representing Councillor Craig Aston)  
Councillor David Snowdon, (Designated Deputy representing Councillor Craig Aston)  
Councillor Carlo Gibbs, (Designated Deputy representing Councillors Anwar Khan, Abdal Ullah, Zenith Rahman and Ahmed Omer)  
Councillor Shiria Khatun, (Designated Deputy representing Councillors Anwar Khan, Abdal Ullah, Zenith Rahman and Ahmed Omer)  
Councillor Mohammed Abdul Mukit MBE, (Designated Deputy representing Councillors Anwar Khan, Abdal Ullah, Zenith Rahman and Ahmed Omer)

**[Note: The quorum for this body is 3 Members].**

If you require any further information relating to this meeting, would like to request a large print, Braille or audio version of this document, or would like to discuss access arrangements or any other special requirements, please contact: Angus Taylor, Democratic Services  
Tel: 020 7364 4333, E:mail: [angus.taylor@towerhamlets.gov.uk](mailto:angus.taylor@towerhamlets.gov.uk)

# LONDON BOROUGH OF TOWER HAMLETS

## PENSIONS COMMITTEE

Thursday, 9 June 2011

7.30 p.m.

### 1. ELECTION OF VICE-CHAIR FOR THE MUNICIPAL YEAR 2011/2012

To receive nominations for the position of Vice- Chair of the Committee for the Municipal Year 2011/2012.

### 2. APOLOGIES FOR ABSENCE

To receive any apologies for absence.

### 3. DECLARATIONS OF INTEREST

To note any declarations of interest made by Members, including those restricting Members from voting on the questions detailed in Section 106 of the Local Government Finance Act, 1992. See attached note from the Chief Executive.

**PAGE  
NUMBER**

**WARD(S)  
AFFECTED**

1 - 2

### 4. UNRESTRICTED MINUTES

To confirm as a correct record of the proceedings the unrestricted minutes of the ordinary meeting of the Pensions Committee held on 18 November 2010.

3 - 6

### 5. PETITIONS

To receive any petitions.

### 6. UNRESTRICTED REPORTS FOR CONSIDERATION

#### 6.1 Pension Committee Terms of Reference, Membership and Quorum (PC/001/112)

7 - 10

All Wards;

**PAGE  
NUMBER**

**WARD(S)  
AFFECTED**

<b>6 .2</b>	<b>Composition of the Pension Fund Investment Panel (PC/002/112)</b>	<b>11 - 16</b>	<b>All Wards;</b>
<b>6 .3</b>	<b>Report of Investment Panel for Quarter Ending 31 December 2010 (PC/003/112)</b>	<b>17 - 22</b>	<b>All Wards;</b>
<b>6 .4</b>	<b>Hutton Commission Report (PC/004/112)</b>	<b>23 - 30</b>	<b>All Wards;</b>
<b>6 .5</b>	<b>Report on Use of Derivatives (PC/005/112)</b>	<b>31 - 36</b>	<b>All Wards;</b>

**7. ANY OTHER UNRESTRICTED BUSINESS  
CONSIDERED TO BE URGENT**

To consider any other unrestricted business that the Chair considers to be urgent.

# Agenda Item 3

## DECLARATIONS OF INTERESTS - NOTE FROM THE CHIEF EXECUTIVE

This note is guidance only. Members should consult the Council's Code of Conduct for further details. Note: Only Members can decide if they have an interest therefore they must make their own decision. If in doubt as to the nature of an interest it is advisable to seek advice **prior** to attending at a meeting.

### Declaration of interests for Members

Where Members have a personal interest in any business of the authority as described in paragraph 4 of the Council's Code of Conduct (contained in part 5 of the Council's Constitution) then s/he must disclose this personal interest as in accordance with paragraph 5 of the Code. Members must disclose the existence and nature of the interest at the start of the meeting and certainly no later than the commencement of the item or where the interest becomes apparent.

You have a **personal interest** in any business of your authority where it relates to or is likely to affect:

- (a) An interest that you must **register**
- (b) An interest that is not on the register, but where the well-being or financial position of you, members of your family, or people with whom you have a close association, is likely to be affected by the business of your authority more than it would affect the majority of inhabitants of the ward affected by the decision.

Where a personal interest is declared a Member may stay and take part in the debate and decision on that item.

**What constitutes a prejudicial interest?** - Please refer to paragraph 6 of the adopted Code of Conduct.

**Your personal interest will also be a prejudicial interest in a matter if (a), (b) and either (c) or (d) below apply:-**

- (a) A member of the public, who knows the relevant facts, would reasonably think that your personal interests are so significant that it is likely to prejudice your judgment of the public interests; AND
- (b) The matter does not fall within one of the exempt categories of decision listed in paragraph 6.2 of the Code; AND EITHER
- (c) The matter affects your financial position or the financial interest of a body with which you are associated; or
- (d) The matter relates to the determination of a licensing or regulatory application

The key points to remember if you have a prejudicial interest in a matter being discussed at a meeting:-

- i. You must declare that you have a prejudicial interest, and the nature of that interest, as soon as that interest becomes apparent to you; and
- ii. You must leave the room for the duration of consideration and decision on the item and not seek to influence the debate or decision unless (iv) below applies; and

- iii. You must not seek to improperly influence a decision in which you have a prejudicial interest.
- iv. If Members of the public are allowed to speak or make representations at the meeting, give evidence or answer questions about the matter, by statutory right or otherwise (e.g. planning or licensing committees), you can declare your prejudicial interest but make representations. However, you must immediately leave the room once you have finished your representations and answered questions (if any). You cannot remain in the meeting or in the public gallery during the debate or decision on the matter.

**LONDON BOROUGH OF TOWER HAMLETS**

**MINUTES OF THE PENSIONS COMMITTEE**

**HELD AT 7.30 P.M. ON THURSDAY, 18 NOVEMBER 2010**

**C1, 1ST FLOOR, TOWN HALL, MULBERRY PLACE, 5 CLOVE CRESCENT,  
LONDON E14 2BG**

**Members Present:**

Councillor Anwar Khan (Chair)  
Councillor Craig Aston  
Councillor Shafiqul Haque

**Others Present:**

John Gray (Unison)  
Frank West (GMB)

**Officers Present:**

Alan Finch – (Service Head, Corporate Finance, Resources)  
Oladapo Shonola – (Chief Financial Strategy Officer, Resources)  
Alan Ingram – (Democratic Services)

**1. ELECTION OF VICE-CHAIR FOR THE MUNICIPAL YEAR 2010/2011**

Councillor Shafiqul Haque **moved**, the Chair **seconded** and it was

**RESOLVED**

That Councillor Shafiqul Haque be elected Vice-Chair of the Pensions Committee for the remainder of the Municipal Year 2010-2011.

**2. APOLOGIES FOR ABSENCE**

Apologies for absence were received on behalf of Councillor Mohammed Abdul Mukit MBE.

**3. DECLARATIONS OF INTEREST**

No declarations of interest were made.

**4. UNRESTRICTED MINUTES**

The Chair **Moved** and it was

**RESOLVED**

That the unrestricted minutes of the ordinary meeting of the Pensions Committee held on 5<sup>th</sup> August 2010 be approved and signed by the Chair as a correct record of the proceedings.

**5. DEPUTATIONS & PETITIONS**

Nil items.

**6. UNRESTRICTED REPORTS FOR CONSIDERATION****6.1 LGPS (Management and Investment of Funds) Regulation 2009**

The Chief Financial Strategy Officer introduced the report. In response to queries he confirmed that proposals to co-mingle cash assets would ensure the best possible returns on investments.

**RESOLVED**

- (1) That the operation of a separate bank account be approved to hold monies held and received on behalf of the Pension Fund to ensure pension fund cash assets are clearly ring-fenced from other monies of the Council.
- (2) That pension fund cash assets continue to be co-mingled with Council Treasury assets to ensure efficient and effective treasury management.
- (3) That pension fund cash assets be invested on a co-mingled basis to ensure that pension fund cash enjoys the same economic rights and return as Council cash assets.

**6.2 Absolute Return Manager Interviews**

The Service Head, Corporate Finance, Resources introduced the item and clarified the process and reasons for the appointment of an absolute return manager for the Pension Fund.

**RESOLVED**

- (1) That Ruffer LLP and Baillie Gifford be appointed to manage absolute manager portfolios for the Fund and that £70m (£35m each) be transferred from cash held and existing equity holdings to fund the mandates.
- (2) That the contracts referred to in (1) above be completed to the satisfaction of the Assistant Chief Executive (Legal Services).

**6.3 Investment Panel for Quarter Ending 30 September 2010**



The Service Head, Corporate Finance, Resources presented the report and commented that references to the quarter ending 30 September should be replaced throughout the report by the quarter ending 30 June. The results of the quarter ending 30 September would be reported to the next meeting of the Committee.

He then commented on the performance of the Fund and, in response to queries, confirmed that volatility in the economies of Ireland and Portugal had the potential to have a knock-on effect on other economies which would not be a positive effect on markets. However, all efforts would be made to minimise losses in that scenario.

### **RESOLVED**

That the report be noted.

## **6.4 2009/10 Local Government Pension Fund Annual Report**

The Chief Financial Strategy Officer introduced the Pension Fund Annual Report, which had been audited and contained minor amendments to the version presented to the Committee on 5<sup>th</sup> August 2010. The report would now be published before the due date of 1<sup>st</sup> December 2010.

### **RESOLVED**

That the report be noted.

## **7. ANY OTHER UNRESTRICTED BUSINESS CONSIDERED TO BE URGENT**

### **7.1 LAPFF Annual Conference**

The Chair stated that this conference would be held from 1<sup>st</sup> to 3<sup>rd</sup> December in Bournemouth and would be attended by the Chief Financial Strategy Officer. The Chair regretted that he would be unable to attend but pointed out that two further places were available for representatives of the Council.

Mr John Gray (Unison) indicated that he would be prepared to attend and agreed to provide an update at the next meeting of the Committee.

### **7.2 Awards Evening**

The Chair indicated that he would provide an update of the event at the next meeting of the Committee.

The meeting ended at 8.00 p.m.

Chair, Councillor Anwar Khan  
Pensions Committee

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# Agenda Item 6.1

<b>Committee</b>	<b>Date</b>	<b>Classification</b>	<b>Report No.</b>	<b>Agenda Item No.</b>
Pensions Committee	9th June 2011	Unrestricted	<b>PC/001/112</b>	
<b>Report of:</b> Service Head, Democratic Services		<b>Title :</b> Pensions Committee Terms of Reference, Membership and Quorum		
<b>Originating Officer(s) :</b> John Williams		<b>Ward(s) affected: N/A</b>		

## 1. Summary

- 1.1 This report sets out the Terms of Reference, Membership and Quorum of the Pensions Committee for the Municipal Year 2011/12 for Members' information.

## 2. Recommendation

- 2.1 That the Pensions Committee note its Terms of Reference, Membership and Quorum as set out in Appendix A to this report.

## 3. Background

- 3.1. At the Annual Council Meeting on 18<sup>th</sup> May 2011, Members were appointed to the various Committees and Panels established for the new municipal year as set out in the Constitution.
- 3.2 The terms of reference for the Pensions Committee together with the appointed Membership and Quorum thereof are set out in Appendix A.

## 4. Membership

- 4.1 Council on 18<sup>th</sup> May 2011 agreed that the Membership of the Committee be set at 7 Members in line with the recommendations of the Constitutional Working Party adopted by Council in April 2010 to ensure the proportionality arrangements are upheld.
- 4.2 Council also agreed that one Admitted Body and one Trade Union representative be invited to join the Committee on a non voting basis in line with the recommendations of the Constitutional Working Party . Officers will verbally update Members on the process for appointing to these positions at the meeting.

## 5. Programme of Meetings

- 5.1 The Council has agreed a programme of meetings for the municipal year. Further meetings of the Pensions Committee are scheduled as follows (start time 7.30 p.m.):

- Thursday 21<sup>st</sup> July 2011
- Thursday 17<sup>th</sup> November 2011;
- Thursday 16<sup>th</sup> February 2012

**4. Comments of the Chief Financial Officer**

There are no specific comments arising from the recommendations in the report.

**5. Concurrent report of the Assistant Chief Executive (Legal)**

The Committee is recommended to note the terms of reference for the current municipal year.

**6. Equal Opportunities Implications**

There are no specific equalities considerations arising from the recommendation in the report.

**7. Anti Poverty Implications**

There are no specific anti poverty implications arising from the recommendations in the report.

**8. Risk Management Implications**

There are no specific risk management implications arising from the recommendations in the report.

**9 Sustainable Action for a Greener Environment**

There are no specific risk management implications arising from the recommendations in the report.

**LOCAL GOVERNMENT ACT, 1972 SECTION 100D (AS AMENDED)  
LIST OF "BACKGROUND PAPERS" USED IN THE PREPARATION OF THIS REPORT**

Brief description of "background paper"

If not supplied  
Name and telephone

**None**

## Appendix A

### PENSIONS COMMITTEE TERMS OF REFERENCE

Terms of Reference:

- To consider pension matters and meet the obligations and the duties of the Council under the Superannuation Act 1972, and the various statutory requirements in respect of investment matters.

Membership:

<b>Members</b>	<b>Substitutes</b>
7 Members of the Council	<b>Up to three substitutes maybe appointed for each Member</b>
Plus one representative of the Admitted Bodies and one Trade Union representative. The Admitted Body and Trade Union representatives will be non-voting members of the Committee.	

At the Annual General Meeting of the Council held on 18<sup>th</sup> May 2011 the following appointments were made to the Pensions Committee.

<b>Members</b>	<b>Substitutes</b>
Cllr Anwar Khan (Chair) Cllr Abdal Ullah Cllr Zenith Rahman Cllr Ahmed Omer	(Deputies:- Cllrs Carlo Gibbs, Shiria Khatun, Abdul Mukit)
Cllr Craig Aston	(Deputies:- Cllr Tim Archer Cllr David Snowdon)
2 Vacancies	
Non Voting Members: - <ul style="list-style-type: none"><li>Trade Union Representative</li><li>Admitted Body</li></ul>	

**The quorum of the Pensions Committee is three Members.**

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# Agenda Item 6.2

<b>COMMITTEE:</b> <b>Pensions Committee</b>	<b>DATE:</b> <b>9<sup>TH</sup> June 2011</b>	<b>CLASSIFICATION:</b> <b>Unrestricted</b>	<b>REPORT NO</b> PC/002/112.	<b>AGENDA NO</b>
<b>REPORT OF:</b> <b>Corporate Director of Resources</b>  <b>ORIGINATING OFFICER(S):</b> <b>Investment Panel</b>		<b>TITLE:</b> <b>Composition of the Pension Fund Investment Panel</b>  <b>Ward(s) affected:</b> <p style="text-align: right;">N/A</p>		

## 1. SUMMARY

- 1.1. This report informs Members of the current arrangements for the provision of Investment advice to this Committee and recommends that these arrangements continue.

## 2. RECOMMENDATIONS

- 2.1 Members are recommended to :
- 2.1.1 To establish an Investment Panel.
- 2.1.2 That membership of the Investment Panel comprise:-
- § All Members of the Pensions and Accounts Committee or their designated deputies.
  - § An Investment Professional as Chair
  - § An Independent Financial Advisor
  - § The Corporate Director of Resources or his designated deputy.
- 2.1.3 Provide that up to two Trade Union representatives (or their designated deputies) as nominated by the Staffside Secretary attend the Investment Panel as observers.
- 2.1.4 To establish terms of reference for the Investment Panel as set out in Appendix 1.

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**LOCAL GOVERNMENT ACT, 1972 SECTION 100D (AS AMENDED)  
LIST OF BACKGROUND PAPERS USED IN THE PREPARATION OF THIS  
REPORT**

Brief description of "background papers"

Brief description of "background papers"  
of "background papers"

None

### **3. BACKGROUND**

- 3.1 The Pension Fund Regulations require the Council to establish arrangements for monitoring the investment activities of the professional fund managers and ensuring that proper advice is available on investment issues.
- 3.2 This role is currently undertaken by the Investment Panel the composition and terms of reference of which were established by this Committee on the 28<sup>th</sup> July 2004.
- 3.3 The terms of reference satisfy the Regulations, which require a formal statement of the responsibilities of the different parties involved in the investment process.

### **4. THE REGULATIONS**

- 4.1 The Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998 require Councils to invest pension fund cash, which is not immediately required to pay pensions.
- 4.2 The Regulations require that Councils when undertaking such investment take proper advice at reasonable intervals and consider the need for diversification of investments.
- 4.3 The Regulations enable Councils to appoint one or more investment managers but in these circumstances are required: -
  - § To take proper advice
  - § To consider at least every three months the investments undertaken by the manager.
  - § To periodically review the managers appointment
- 4.4 To satisfy the requirement to obtain proper advice the Council has engaged an investment professional to act as chair of the investment panel and a firm of investment consultants to advise on the technical issues.
- 4.5 In addition the Council employs an independent performance measurement service to provide an analysis of individual manager's performance on a quarterly basis.
- 4.6 The Regulations have been supplemented by guidance on best practice issued by the Chartered Institute of Public Finance and Accountancy (CIPFA) in response to the Myners report, an independent review of pension investment, which reported in 2001.
- 4.7 The CIPFA best practice guidance sets out the responsibilities of the different parties involved in the investment process and requires that a periodic review be made of these arrangements and of the performance of the individual parties.

### **5. CURRENT ARRANGEMENTS**

- 5.1 Currently the Council is advised on investment issues by a Investment Panel which holds morning meetings on a quarterly basis and comprises the following members :-



- § An independent Chair (Raymond Haines)
  - § All Members of the Pensions and Accounts Committee or their designated deputies.
  - § An independent advisor (Hymans Robertson & Co.)
  - § The Corporate Director of Resources or his designated deputy.
  - § Two observers from the Trade Unions.
- 5.2 The terms of reference of the Investment panel were established by this Committee on the 28<sup>th</sup> July 2004 and satisfy the requirements of the Regulations.
- 5.3 It should be noted that the Investment Panel is purely advisory and has no executive powers. It advises this Committee on investment issues and this Committee decides on the basis of this advice what action is appropriate.
- 5.4 The terms of reference of the Investment Panel are as set out in Appendix 1.

## **6. COMMENTS OF THE CHIEF FINANCIAL OFFICER**

- 6.1. The comments of the Corporate Director of Resources have been incorporated into the report.

## **7. RISK MANAGEMENT IMPLICATIONS**

- 7.1 There is inevitably a relatively high degree of risk associated with investment in financial markets.
- 7.2 The Regulations attempt to mitigate this risk by ensuring that arrangements are in place to monitor the activities of investment managers and proper advice is taken.

## **8. CONCURRENT REPORT OF THE ASSISTANT CHIEF EXECUTIVE (LEGAL)**

- 8.1 It is open to a committee appointed by the Council to appoint a sub-committee for the purposes of discharging its functions. The requirements for such an appointment are set out in Part 6 of the Local Government Act 1972.
- 8.2 It is understood, however, that the proposed Pension Fund Investment Panel is not to be a formal sub-committee but instead will be in the nature of a working group. On this basis, the Pension Fund Investment Panel may not exercise any of the functions of the Pensions Committee. The Panel may provide information to the Pensions Committee for its consideration. It will remain the responsibility of the Pensions Committee to make all relevant decisions within its terms of reference.

## **9. ANTI-POVERTY IMPLICATIONS**

- 9.1 There is no specific anti poverty implications.

## **10. ONE TOWER HAMLETS**

10.1 The Council will select the chair, independent financial adviser and trade union representatives pursuant to open and fair processes that meet the requirements of the Equality Act 2010.

**11. SUSTAINABLE ACTION FOR A GREENER ENVIRONMENT**

11.1 There are no Sustainable Action for A Greener Environment implications.

## **APPENDIX 1: INVESTMENT PANEL TERMS OF REFERENCE**

The Investment Panel is responsible for monitoring all aspects relating to the investment of the assets of the Scheme. Its specific responsibilities are as follows: -

- The Investment Panel will formally review the Scheme's asset allocation at least every three year's taking account of any changes in the profile of Scheme liabilities and will assess any guidance regarding tolerance of risk. It will recommend changes in asset allocation to the Pensions Committee.
- The Investment Panel will consider and monitor the Quarterly Reports produced by their Investment Managers and independently produced performance measurement reports. The contents and formats of the reports will be specified by the Investment Panel.
- The Investment Panel will formally review annually each manager's mandate, and its adherence to its expected investment process and style. The Investment Panel will ensure that the explicit written mandate of each of the investment managers is consistent with the Scheme's overall objectives and is appropriately defined in terms of performance target, risk parameters and timescale.
- The Investment Panel will consider the need for any changes to the Scheme's investment manager arrangements (e.g. replacement, addition, termination) at least annually and make recommendations to the Pension and Accounts Committee if necessary.
- In the event of a proposed change of managers, the Investment Panel will evaluate the credentials of potential managers and make recommendations to the Pensions Committee
- The Investment Panel will consider the Scheme's approach to social, ethical and environmental issues of investment, corporate governance and shareholder activism and recommend revisions to the Pensions Committee.
- The Investment Panel will review the Scheme's AVC arrangements annually. If it considers a change is appropriate, it will make recommendations to the Pensions Committee.
- The Investment Panel will assess the investment advice from their investment consultant and investment services obtained from other providers (e.g. custodian) at least annually.
- The Investment Panel will consider and conclude the negotiation of formal agreements with managers, custodians and other investment service providers on behalf of the Pensions Committee.
- The Investment Panel is able to take such professional advice, as it considers necessary in order to fulfil its responsibilities.
- The Investment Panel will keep Minutes and other appropriate records of its proceedings, and circulate these minutes to the Pensions Committee.
- The Investment Panel may also carry out any additional tasks delegated to it by the Pensions Committee.

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# Agenda Item 6.3

<b>COMMITTEE:</b> <b>Pensions Committee</b>	<b>DATE:</b> <b>9 June 2011</b>	<b>CLASSIFICATION:</b> <b>Unrestricted</b>	<b>REPORT NO</b> PC/003/112	<b>AGENDA NO.</b>
<b>REPORT OF:</b> <b>Corporate Director of Resources</b>		<b>TITLE:</b> <b>Report of Investment Panel for Quarter Ending 31 December 2010.</b>		
<b>ORIGINATING OFFICER(S):</b> <b>Oladapo Shonola – Chief Financial Strategy Officer</b>		<b>Ward(s) affected:</b> N/A		

<b>Lead Member</b>	<b>Cllr Anwar Khan, Chair of Pension Committee</b>
<b>Community Plan Theme</b>	<b>All</b>
<b>Strategic Priority</b>	<b>One Tower Hamlets</b>

## **1. SUMMARY**

- 1.1 This report informs Members of the activities of the Investment Panel and the performance of the Fund and its investment managers for the period ending 31 December 2010.
- 1.2 In the quarter to the end of December 2010 the Fund achieved a return of -6.0% which is 0.1% above the benchmark. The twelve month Fund return of 12.4% slightly underperformed the benchmark return at 12.8%. For longer periods, performance continued to lag behind the benchmark with the three years return of 2.5% underperforming the benchmark return of 2.9% by 0.4% and the five years return of 4.4% underperforming the benchmark return of 5.0% by 0.6%.
- 1.3 The performance of individual managers was mostly positive this quarter. Five managers matched or achieved returns above the benchmark whilst two were below. The variability of returns does however partially reflect the management structure of the fund where complementary investment styles reduce the volatility of returns.
- 1.4 The distribution of the Fund amongst the different asset classes is broadly in line with the benchmark.

## **2. DECISIONS REQUIRED**

- 2.1 Members are recommended to note the contents of this report.

## **3. REASONS FOR DECISIONS**

- 3.1 There are no decisions to be made as a result of this report. The report is written to inform panel members of the performance of pension fund managers and the overall performance of the Tower Hamlets Pension Fund. The report also updates the Committee on the activities of the Investment Panel.

## 4. ALTERNATIVE OPTIONS

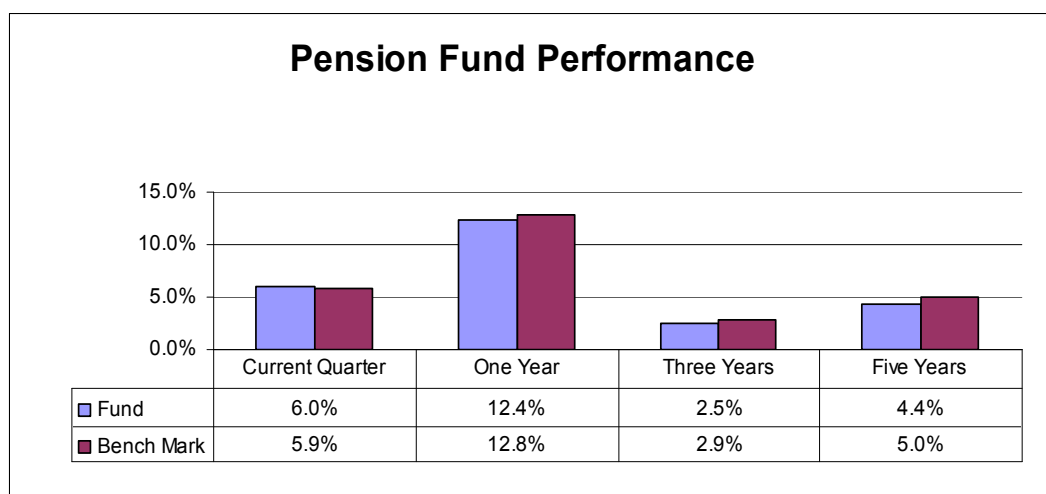
- 4.1 The Pension Fund Regulations requires that the Council establishes arrangements for monitoring the investments of the Pension Fund. Under the constitution of Tower Hamlets Council this is the responsibility of the Pensions Committee.

## 5. BACKGROUND

- 5.1 The Pension Fund Regulations require that the Council establish arrangements for monitoring the investments of the Fund and the activities of the investment managers and ensure that proper advice is obtained on investment issues.
- 5.2 This Committee has established the Investment Panel, which meets quarterly for this purpose. The Panel's membership comprises all Members of the Pensions Committee, an Investment Professional as Chair, an Independent Financial Adviser, and the Corporate Director of Resources represented by the Service Head – Finance, Risk and Accountability, two trade union representatives and one representative of the admitted bodies. The Investment Panel is an advisory body which makes recommendations to the Pensions Committee, which is the decision making body.
- 5.3 This report informs Members of the activities of the Investment Panel and performance of the Fund and its investment managers for the period ending 31 December 2010.

## 6 INVESTMENT PERFORMANCE

- 6.1 The Fund achieved a return of 6.0% which is 0.1% above the benchmark.
- 6.2 The performance of the fund over the longer term is as set out in table 1.



- 6.3 The chart clearly demonstrates the volatility and cyclical nature of financial markets, but the outcomes are within the range of expectations used by the Fund actuary in assessing the funding position. The Fund can take a long term perspective on investment issues principally because a high proportion of its pensions liabilities are up to sixty years in the future. Consequently it can effectively ride out short term volatility in markets.

## 7. MANAGERS

- 7.1 The Fund currently employs seven specialist managers with mandates corresponding to the principal asset classes. The managers are as set out below: (figures are for December 2010)

Table 2: Management Structure

Manager	Mandate	Value £M	Target % of Fund	Actual % of Fund	Difference %	Date Appointed
GMO	Global Equity	210.5	25.0%	26.1%	1.1%	29 Apr 2005
Baillie Gifford	Global Equity	145.9	16.0%	18.1%	2.1%	5 Jul 2007
L & G UK Equity	UK Equity	176.9	22.5%	22.0%	-0.5%	2 Aug 2010
L & G Index Linked-Gilts	UK Equity	53.4	7.0%	6.6%	-0.4%	2 Aug 2010
Investec Bonds	Bonds	97.0	14.0%	12.0%	-2.0%	26 Apr 2010
Schroder	Property	90.0	12.0%	11.2%	-0.8%	30 Sep 2004
Record	Currency	5.0	1.5%	0.6%	-0.9%	2 Sep 2008
Cash	Currency	26.9	2.0%	3.3%	1.3%	
<b>Total</b>		<b>805.7</b>	<b>100.0%</b>	<b>100.0%</b>	<b>0.0%</b>	

- 7.2 The fund value of £805.7 million held by the managers has increased by £56.8 million (7.58%) over the quarter.
- 7.3 Following a decision taken by the Panel, new absolute returns mandates have been awarded (totalling 10% of the Fund's assets) in Q1 2011. These have been awarded to Ruffer LLP (£40m) and Baillie Gifford (£40m), for investment in its Diversified Growth Fund. The new portfolios have been funded by the proceeds of the Record disinvestment, internal cash and transfer of assets from Baillie Gifford, Legal & General and GMO.
- 7.4 The performance of the individual managers relative to the appropriate benchmarks over the past five years is as set out in table 3.

Table 3: Manager Investment Performance relative to benchmark

Manager	Current Quarter	One Year	Three Years	Five Years
GMO	-0.70%	0.00%	0.30%	-0.20%
Baillie Gifford	0.20%	4.70%	2.80%	2.60%
L & G UK Equity	0.00%	0.00%		
L & G Index Linked-Gilts	0.00%	0.00%		
Investec Bonds	0.90%	-2.00%		
Schroder	0.10%	-3.50%	-1.20%	0.30%
Record	-6.70%	-33.00%	-25.10%	
<b>Total Variance (Relative)</b>	<b>0.20%</b>	<b>-0.40%</b>	<b>-0.40%</b>	<b>-0.60%</b>

- 7.5 **GMO** under-performed in the quarter, trailing the benchmark in relative terms by 0.7%. This is mainly due to the stock selection but some of this was offset by positive contributions from the momentum stock and the newly introduced enhanced currency approach.
- 7.6 **Baillie Gifford** Performance has dropped back in the quarter although continues to be strong and significantly ahead of the benchmark over the year (4.7%), and since inception. The main contributors to performance in the quarter were recovering industrial companies and internet companies whilst Financials became the largest negative contributors. Baillie Gifford believe that emerging market growth will continue to be strong and make a positive contribution to global growth. Baillie Gifford have recently made some partnership changes but this is not expected to affect the management of the portfolio.
- 7.7 **L & G (UK Equity)** performance has been in line with the index benchmark (FTSE-All Share) since inception, as expected.
- 7.8 **L & G Index Linked Gilts** performance has been in line with the index benchmark (FTSE-A Index-Linked Over 15 Years Gilts) since inception.
- 7.9 **Schroder (property)** Schroder out-performed the benchmark in the quarter by 0.10% ending four quarters of relative under performance (3.5%). Performance has improved as the cash holding has been invested and the impact of the European exposure has lessened.
- 7.10 **Investec (Bonds)** Investec continue to return a relative out performance (0.9%), with corporate bonds and interest rate positions being the main positive contributors. They have reduced their exposure to banking and corporate bonds which has proved beneficial.
- 7.11 **Record** Continuing poor performance for Q4 2010. The Long Euro position has detracted from performance over the quarter as the Euro was the weakest currency in the G11 during this period. Following a decision taken by The Panel the funds held by Record were disinvested in Q1 2011 with the proceeds being used to fund the newly awarded absolute return mandates.

## **8 ASSET ALLOCATION**

- 8.1 The allocation of investments between the different asset classes was determined in conjunction with the Council's professional advisors in 2004 and is subject to periodic review by the Investment Panel. Asset allocation is determined by a number of factors including:-
- 8.1.1 The risk profile. Generally there is a trade-off between the returns obtainable on investments and the level of risk. Equities have higher potential returns but this is achieved with higher volatility. However, as the Fund remains open to new members and able to tolerate this it can seek long term benefits of the increased returns.
- 8.1.2 The age profile of the Fund. The younger the members of the Fund, the longer the period before pensions become payable and investments have to be realised for this purpose. This enables the Fund to invest in more volatile asset classes because it has the capacity to ride out adverse movements in the investment cycle.



- 8.1.3 The deficit recovery term. All Council funds are in deficit because of falling investment returns and increasing life expectancy. The actuary determines the period over which the deficit is to be recovered and considers the need to stabilise the employer's contribution rate. The actuary has set a twenty year deficit recovery term for this Council which enables a longer term investment perspective to be taken.
- 8.2 The benchmark asset distribution and the position at the 31 December 2010 are as set out below:

**Table 4: Asset Allocation**

<b>Mandate</b>	<b>Benchmark 31 Dec 2010</b>	<b>Fund Position</b>	<b>Variance as at 31 Dec 2010</b>	<b>Variance as at 31 Mar 2010</b>
UK Equities	26.5%	27.3%	0.8%	1.1%
Global Equities	37.0%	38.1%	1.9%	1.0%
Total Equities	63.5%	65.4%	2.7%	2.1%
Property	12.0%	10.7%	-1.3%	1.1%
UK Bonds	14.0%	12.0%	-2.0%	-0.7%
Overseas Bonds	0.0%	0.0%	0.0%	-2.0%
UK Index Linked	7.0%	6.7%	-0.3%	-1.3%
Cash	2.0%	4.6%	2.6%	2.8%
Currency	1.5%	0.6%	-0.9%	0.1%
<b>Total Equities</b>	<b>100.0%</b>	<b>100.0%</b>		

- 8.3 Individual managers have discretion within defined limits to vary the asset distribution.
- 8.4 In addition the distribution will vary according to the relative returns of the different asset classes. Equity markets have been recovering over the past several months and indexes are now nearing pre-recession levels. This has corrected the temporary distortion in the distribution of assets, so that the actual distribution of assets is similar to targets. But superior outperformance by equities over other asset classes means that the portfolio is overweight equities.

## **9. COMMENTS OF THE CHIEF FINANCIAL OFFICER**

- 9.1. The comments of the Corporate Director Resources have been incorporated into the report.

## **10. CONCURRENT REPORT OF THE ASSISTANT CHIEF EXECUTIVE (LEGAL)**

- 10.1 The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 require the Council, as an administering authority, to invest fund money that is not needed immediately to make payments from the Pensions Fund. The Council is required to have a policy in relation to its investments and a Statement of Investment Principles. The Council is required to take advice about its investments.

- 10.2 The Council does not have to invest the fund money itself and may appoint one or more investment managers. Where the Council appoints an investment manager, it must keep the manager's performance under review. At least once every three months the Council must review the investments that the manager has made and, periodically, the Council must consider whether or not to retain that manager.
- 10.3 One of the functions of the Pensions Committee is to meet the Council's duties in respect of investment matters. It is appropriate, having regard to these matters, for the Committee to receive information about asset allocation and the performance of appointed investment managers.

## **11. ONE TOWER HAMLETS CONSIDERATIONS**

- 11.1 The employer's contribution is a significant element of the Council's budget and consequently any improvement in investment performance will reduce the contribution and increase the funds available for other corporate priorities.
- 11.2 A viable pension scheme also represents an asset for the recruitment and retention of staff to deliver services to the residents.

## **12. SUSTAINABLE ACTION FOR A GREENER ENVIRONMENT**

- 12.1 There is no Sustainable Action for A Greener Environment implication arising from this report.

## **13. RISK MANAGEMENT IMPLICATIONS**

- 13.1 Any form of investment inevitably involves a degree of risk.
- 13.2 To minimise risk the Investment Panel attempts to achieve a diversified portfolio. Diversification relates to asset classes and management styles.

## **14. CRIME AND DISORDER REDUCTION IMPLICATIONS**

- 14.1 There are no crime and disorder reduction implications arising from this report.

## **15. EFFICIENCY STATEMENT**

- 15.1 The monitoring arrangement for the Pension Fund and the work of the Pension Fund Investment Panel should ensure that the Fund optimises the use of its resources in achieving the best returns for members of the Fund.

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### **LOCAL GOVERNMENT ACT 1972 (AS AMENDED) SECTION 100D**

#### **LIST OF "BACKGROUND PAPERS" USED IN THE PREPARATION OF THIS REPORT**

***Brief description of "background papers"***

*Review of Investment Managers' Performance for the 4<sup>th</sup> Quarter Report – prepared by Hymans Robertson LLP*

***Name and telephone number of holder  
And address where open to inspection***

*Oladapo Shonola Ext. 4733  
Mulberry Place, 4<sup>th</sup> Floor.*

# Agenda Item 6.4

<b>Committee/Meeting:</b> <b>Pensions Committee</b>	<b>Date:</b> <b>9 June 2011</b>	<b>Classification:</b> Unrestricted	<b>Report No:</b> PC/004/112
<b>Report of:</b> Corporate Director Resources		<b>Title:</b> Hutton Commission Report	
<b>Originating officer(s)</b> Alan Finch, Service Head – Finance, Risk & Accountability ; Oladapo Shonola, Chief Financial Strategy Officer		<b>Wards Affected:</b> All	

<b>Lead Member</b>	Cllr Anwar Khan, Chair of Pensions Committee
<b>Community Plan Theme</b>	All
<b>Strategic Priority</b>	All

## 1 **SUMMARY**

- 1.1. At the November 2010 meeting of the Committee, Members requested an update on the work of the independent Public Service Pensions Commission, led by the former Cabinet Minister John Hutton. This report provides that information.
- 1.2. The Hutton Commission was established by the Chancellor of the Exchequer in June 2010 to undertake a fundamental review of public service pensions provision by the time of the next Budget in April 2011. Having issued an interim report in October 2010, the Hutton Commission issued its final report in March 2011.
- 1.3. In the Budget, the Government announced “The Government accepts Lord Hutton’s recommendations as a basis for consultation with public sector workers, trades unions and others.... The Government will set out proposals in the autumn that are affordable, sustainable and fair to both the public sector workforce and the taxpayer”.

## 2 **DECISIONS REQUIRED**

**The Committee is recommended to:-**

- 2.1 Note the report into the work of the independent Public Service Pensions Commission and that officers will report back when there are any further developments on this issue of public sector pension reforms.

### **3 REASONS FOR THE DECISIONS**

- 3.1 Members requested this report in order to update themselves on the work of the Hutton Commission.

### **4 ALTERNATIVE OPTIONS**

- 4.1. No decision is required at this stage.

### **5 BACKGROUND**

- 5.1. The issue of public sector pension provision has moved up the political agenda in recent years, largely because;
- The cost of all pension schemes has increased substantially due to increased longevity.
  - The closure of many Company defined benefits schemes increasingly makes public sector schemes seem generous in comparison to the provision available to other workers.
  - The nature of the schemes is such that responsibility for any deficit rests with the taxpayer and not with the beneficiary, so that the cost of the schemes for the taxpayer, whether now or in the future, has increased.
- 5.2. The Coalition Agreement committed the Government to establishing an independent commission to review the long term affordability of public sector pensions, while protecting accrued rights. Subsequently, in June, the Chancellor announced that the Commission would be set up, under Lord Hutton of Furness (John Hutton), the former Labour Secretary of State for Work and Pensions, to undertake a fundamental structural review of public service pension provision. The commission was asked to “make recommendations on how public service pensions can be made sustainable and affordable in the long-term, fair to both the public service workforce and the taxpayer, and ensure that they are consistent with the fiscal challenges ahead”.
- 5.3. The Commission was asked to consider a range of issues including:
- the disparity between public service and private sector pension provision;

- the need to ensure that future pension provision is fair across the workforce;
  - how risk should be shared between the taxpayer and employee; and
  - wider Government policy intended to encourage adequate saving for retirement and longer working lives.
- 5.4. The Commission was asked to report in time for the next Budget, which has been announced for 23<sup>rd</sup> March 2011, and to issue an interim report in time for the Spending Review in October. The interim report was published on 7<sup>th</sup> October 2010 and the final report 10<sup>th</sup> March 2011.

## **6. Final Report**

- 6.1. The final report makes 27 recommendations in all, but the main recommendation is for a move away from the existing final salary benefit scheme to a career average structure scheme. Although, he recommends that any accrued rights under the existing scheme should be preserved.
- 6.2 The report emphasises the importance of public service pensions but points out that most schemes were last substantially reformed in the 1970s, since which time the context within which they operate has changed substantially. In the early 1970s, the life expectancy at age 60 was 18 years, now it is 28 years. In addition, many more people reach the age of 60. A man who retires at 60 can now expect to live more than 40% of his adult life in retirement and the figure is higher for women.
- 6.3 Some limited reforms have taken place in recent years. These include;
- The change in indexation from Retail Prices Index (RPI) to Consumer Prices Index (CPI), which in the run will increase pension benefits by a lesser amount year on year.
  - Increases in pensionable age, which in the Local Government Scheme means that staff will ultimately not receive access to their pension until the age of 65 (previously 60).
  - Introduction of differential employee contribution rates in the Local Government scheme so that rates now increase from 5.5% to 7.5% with increasing pay (replacing the previous 6% standard rate).
- 6.4. The drawback is that most of these measures will not affect the costs of the schemes for many decades.

6.5. The Commission has set a number of principles for future public service pension provision;

- Affordability and sustainability

The question of affordability is ultimately a matter for political choice, but this decision needs to be taken in the context of a sustainably and affordable scheme (i.e. not one that simply shunts costs onto later generations).

- Adequacy and fairness

Pensions should provide an adequate retirement pension for public sector workers, maintaining a balance of fairness between workers, and between pensioners and taxpayers.

- Supporting Productivity

The pension schemes should offer value for money and should not be a barrier to measures that improve productivity and efficiency, such as outsourcing or mutualisation.

- Transparency and simplicity

Schemes should be widely understood by beneficiaries and taxpayers

6.6. The report recommends an increase in contribution rates as a means for savings in the short. The Commission said this should be done in such a way as it protects the low paid and does not impact significantly on opt out rates. The Government has already adopted this recommendation and plan to implement it in a way that ensures that increased contributions will fall more heavily on higher earners. Although, there is a danger that any significant rise in rates would simply lead to more staff leaving the schemes, which would be counter-productive in terms of one of the Commission's principles of sustainability.

6.7. The report has come down against pure defined contribution schemes which it says would not necessarily be cheaper to fund, result in uncertainty of benefits for scheme members, including the low paid, and not make the best

use of the ability of the Government, as a large employer, to manage some of the schemes' risks.

6.8. Other notable recommendations include:

- the immediate increase of retirement age to 65 years for new entrants and to age 68 by 2046. Some research as shown that the proposed increase is not enough to keep pace with the rate of increase in longevity
- Replacement of Pension Committees with Pension Boards with member nominees
- Regular analysis of the fiscal impact of the schemes by the office for Budget Responsibility
- No access to public service pension schemes by future non-public service workers – this could lead to significant reduction in fund membership.

6.9 The Final Report is available in full at the following website:

[http://www.hm-treasury.gov.uk/indreview\\_johnhutton\\_pensions.htm](http://www.hm-treasury.gov.uk/indreview_johnhutton_pensions.htm)

6.10 The Government has responded by accepting the report as a basis for consultation and stating that proposals will be issued in the Autumn

6.11 At the Tower Hamlets Council meeting in April, the Council passed a resolution that the Council write to the Chancellor of the Exchequer calling for the Government to rethink its proposed increases to LGPS member contributions and resolved to work with Trade Unions to ensure employees are made aware of the proposals for the LGPS and to encourage them to support the Council's representations to defend their pension scheme. This letter has been sent.

## **7. Officers Remarks**

- 7.1. This section of the report comprises some general remarks by officers on the principles of the reforms as put forward by Hutton. It is important to note that the Hutton Commission is reviewing pension provision across the public sector as a whole and not just in Local Government. The LGPS differs from most other public sector schemes in that it is a funded scheme, although the majority of funds are not currently fully funded, and it is managed locally by trustees within each local authority (the Pensions Committee in Tower Hamlets). Some of the criticism of the public sector pension schemes has been levelled at 'pay as you go' schemes such as the civil service, teachers and NHS schemes, and the LGPS is not in the same category. Nevertheless it is a statutory, defined benefits scheme based on final salary and its costs have risen over the years as longevity has risen.
- 7.2. There can also be little doubt that change needs to take place in order to adapt the scheme to the conditions of the 21<sup>st</sup> Century. For example, the use of a final salary scheme in an era when senior public sector salaries have increased far beyond what they were when the schemes were established no longer seems tenable. Much of the bad publicity for the scheme arises from the apparent generosity of so-called 'gold plated' pensions for 'fat cats', which has skewed debate and distracted from the fact that most local government pensions are small amounts. (The average annual pension payment in the Tower Hamlets scheme in 2009/10 was £7,400). In principle, changing to a career average scheme will have more impact on higher paid staff, as for these staff their final salary is likely to be much higher than their career average. Graduated contribution rates also have more impact on the higher paid. These principles could therefore be seen as introducing greater fairness into the LGPS.
- 7.3. The alternative to reform along the lines of the Commission's principles would be to allow the schemes to be adapted piecemeal by successive Governments in a bid to control costs. Such piecemeal change has already taken place to some extent and arguably these changes do not receive appropriate scrutiny. For example the switch from RPI to CPI indexation has reduced the benefits that existing pensioners would otherwise have received in a way that is not very transparent. A reform package that establishes a fair, affordable and sustainable scheme for the foreseeable future is arguably preferable to employers, scheme members and taxpayers than a series of marginal changes to the scheme that lack clear accountability.
- 7.4 The Government has promised to protect accrued rights, (although changing indexation from RPI to CPI is a grey area) and it appears that this promise will be met. This could be seen as an important principle in terms of natural justice, since staff entitled to accrued benefits have already undertaken the



work that earned them those benefits, although it does mean that the benefits of pensions reform in terms of reduced costs will take quite some time to emerge. Furthermore the Hutton Commission has stated that it is not an option to reduce public service pension provision to the level of a lowest common denominator if the state is to attract a suitably motivated and trained workforce.

- 7.5. In view of the fact that public sector staff are also seeing a real terms reduction in pay as a result of the pay freeze and high rates of inflation, there is a risk that some staff will decide that they cannot afford to pay the additional contributions and leave the fund. If this happens on a large scale then the costs of maintaining the LGPS could increase in the short term, because the Fund would lose some of the liquidity benefit of employee contributions and investment performance would need to rise. For those staff who can be persuaded to take a longer view, however, the LGPS is likely to remain a good value, subsidised pension scheme in comparison to available alternatives.
- 7.6 The Chancellor welcomed the report and a consultation is expected to be launched that is likely to conclude in the autumn of 2011. Therefore, it is going to be some months before we have definitive answers as to which recommendations have survived and how Local Government Pension Scheme (LGPS) will look going forward.
- 7.7. Officers will report back to the Committee if there are any further developments in this area, prior to or after consultation has been concluded.

## **8 COMMENTS OF THE CHIEF FINANCIAL OFFICER**

The Council contributes £39m a year to the Pension Fund which supports current and future benefits to around 5,100 existing members of staff and 9,600 former employees. At the time of the 2010 actuarial valuation, the scheme liabilities were valued at £1,077m and these were 70% funded by the market valuation of assets.

## **9 CONCURRENT REPORT OF THE ASSISTANT CHIEF EXECUTIVE (LEGAL SERVICES)**

- 9.1 The LGPS is a national scheme, administered locally. The scheme is closely governed by a suite of regulations made pursuant to section 7 of the Superannuation Act 1972. The LGPS (Administration) regulation 2008 are

particularly significant in the context of the Hutton Commission's work, as they deal with matters such as membership, contribution and payment of benefits. Any reform of the LGPS flowing from the Commission's recommendations would involve amendment of the statutory scheme. Advice can be provided about any such amendments as and when the details become available.

## **10 ONE TOWER HAMLETS CONSIDERATIONS**

- 10.1 All employees of the London Borough of Tower Hamlets are entitled to join the Pension Scheme.

## **11 SUSTAINABLE ACTION FOR A GREENER ENVIRONMENT**

- 11.1 There are no direct SAGE implications.

## **12 RISK MANAGEMENT IMPLICATIONS**

- 12.1 The governance of the Pension Fund has its own risk management arrangements. These are not directly affected by the issues raised in this report.

## **13 CRIME AND DISORDER REDUCTION IMPLICATIONS**

- 13.1 There are no direct crime and disorder reduction implications.

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### **Local Government Act, 1972 Section 100D (As amended) List of "Background Papers" used in the preparation of this report**

No "background papers" were used in writing this report

# Agenda Item 6.5

<b>COMMITTEE:</b> <b>Pensions Committee</b>	<b>DATE:</b> <b>9 June 2011</b>	<b>CLASSIFICATION:</b> <b>Unrestricted</b>	<b>REPORT NO</b> PC/005/112.	<b>AGENDA NO.</b>
<b>REPORT OF:</b> <b>Corporate Director of Resources</b>  <b>ORIGINATING OFFICER(S):</b> <b>Oladapo Shonola – Chief Financial Strategy Officer</b>		<b>TITLE:</b> <b>Report on Use of Derivatives</b>  <b>Ward(s) affected:</b> N/A		

<b>Lead Member</b>	<b>Cllr Anwar Khan, Chair of Pensions Committee</b>
<b>Community Plan Theme</b>	<b>All</b>
<b>Strategic Priority</b>	<b>One Tower Hamlets</b>

## 1. SUMMARY

- 1.1 This report highlights to Members the use of derivative contracts by investment managers to minimise exposure of Pension Fund assets to currency risk and ensure optimum portfolio efficiency.
- 1.2 The pension fund strategy has been agreed by the Members in the past to ensure that future liabilities of the Fund can be discharged as they fall due. As part of the continuous performance management, the fund strategy is periodically reviewed.
- 1.3 As decisions have been taken about investments in the past, the Pensions Committee has been made aware of the use of derivatives in the Fund. However, in the interests of enhanced governance, the Council's external auditors have asked officers to provide Members with a more detailed report on this subject. Therefore, this report seeks to give a fuller briefing on derivatives, their purpose and use by the Funds investment managers.
- 1.4 A number of investment managers are permitted under the conditions of investment agreed during the contract award process to use derivatives in the form of forward foreign exchange contracts to manage exposure to currency risk as part of an overall strategy to ensuring efficient management of fund assets.
- 1.5 To this end, managers are permitted to use forward foreign exchange contracts, but are also restricted in the use of such financial instruments to mostly cover currency risk. Pension Fund investment managers are not permitted to indiscriminately speculate (i.e. hedge fund type activity) in order to make a profit when using forward contracts, but as a tool to minimise risk and optimise portfolio performance. Therefore, forward foreign exchange deals are not traded primarily for profit, but to minimise currency risk exposure.

## 2. DECISIONS REQUIRED

- 2.1 Members are recommended to note the contents of this report.

### **3. REASONS FOR DECISIONS**

- 3.1 There are no decisions to be made as a result of this report. The report is written to inform committee members of how some investment managers have been permitted under the terms of their contract with London Borough of Tower Hamlets Pension Fund to use derivative contracts to manage exposure to currency risk.

### **4. ALTERNATIVE OPTIONS**

- 4.1 Members can instruct investment managers to not cover currency risk using forward foreign exchange contracts, but that is likely to have a significant impact on the security of fund assets. This is also likely to introduce considerably more volatility into the portfolio of assets.
- 4.2 If this option was to be taken, it is likely to lead to more indirect loss of value of asset due to currency movement between Sterling and other currencies that investment managers trade in. Consequently, the investment strategy will need to be revised to cover this shortfall which would mean taking more risk in the types of assets that the Fund invests in.
- 4.3 Another consideration is to what extent Members can instruct investment managers to refrain from using derivatives without such an instruction leading to the termination of the contract. Of the 5 mandates that currently use derivatives, 4 are pooled funds. Where the pension fund is invested in a pooled fund it will not be able to operate a strategy specific to London Borough of Tower Hamlets Pension Fund (e.g. no trading in derivatives) that is different to the investment manager's overall investment strategy.
- 4.4 This complication means that should Members choose to instruct investment managers not to use derivatives these 4 mandates will likely be terminated.

### **5. BACKGROUND**

- 5.1 The Pension Fund Regulations require that the Council establish arrangements for monitoring the investments of the Fund and the activities of the investment managers and ensure that proper advice is obtained on investment issues.
- 5.2 This report is supplementary to the regular report that is presented to this Committee on a quarterly basis and deals specifically with the issue of the use of derivatives to manage pension fund assets.
- 5.3 At the last audit of the Pension Fund, the Council's external auditors reviewed the accounting and reporting of derivatives in the Fund. They recommended that to enhance governance, Members should be made aware that investment managers employ derivatives within their mandates/ allocated assets.

- 5.4 Officers made it clear to the auditors that Members were already aware of this as it is embedded in our processes as part of regular discussions with Members.
- 5.5 Members are briefed when a new mandate/asset allocation is made within the Fund. So for example, the papers that went to Members in 18 November 2009 on the establishment of an Absolute Return (Equity) mandate talks explicitly about the use of derivatives to manage any allocation to this asset class. The report stated that:
- “...some manager will use derivatives to ‘hedge’ or control exposure to market risk, these products are generally long-only in intent. They often have an equity bias, do not employ gearing and are transparent in nature.”*
- 5.6 In the same paper to Members on 18 November 2009, the following comment was made regarding the manner in which Ruffer (Absolute Return Mandate Manager) uses derivatives
- “Derivatives are used only for currency positioning or to hedge currency exposure through forward currency contracts.”*
- 5.7 Where derivatives has had a significant impact on a manager’s performance, this is reported to Members through the quarterly monitoring process as was the case on 17 February 2011 report which stated that:
- “Investec will use derivatives to benefit both from rising and falling global bond markets...”*
- 5.8 On the other side of the coin is Schroder’s policy of not entering into forward foreign currency contracts to cover non sterling positions, which has often impacted on their performance. This is an issue that Schroder’s actively manages and has been discussed at Investment Panel with Members on a number of occasions.

## **6 DERIVATIVES**

- 6.1 A derivative is defined as a financial instrument whose value depends on other...underlying variables such as underlying assets...volatilities, etc. The main categories of derivatives are futures, options and swaps. The Fund’s investment managers trade in futures to cover a position they have taken in the market.
- 6.2 Although, there are those that bet on certain outcomes (i.e. speculate in order to profit), this is not an investment strategy that is used by the Fund’s investment managers and where derivatives are used for purposes other than for covering market positions/mitigate risk they are used within the scope of the mandate – that is as a tool to enhance the portfolio.
- 6.3 The 2009-10 annual statement of accounts breaks down the funds exposure to forward foreign exchange contracts as at the 31 march 2010. This showed that the transactions entered into by the funds investment managers had a net positive effect on the overall value of the Fund.

- 6.4 There are certain asset classes within the London Borough of Tower Hamlets' Pension Fund that intrinsically need the flexibility provided by derivatives to optimise portfolio efficiency. The extent to which these instruments can be utilised are restricted by the fund management contract between the investment manager and the Pension Fund.
- 6.5 To illustrate why it is often necessary to take out a forward foreign exchange contract to cover currency risk as part of a comprehensive investment strategy, take an equity stock that has performed reasonably well through the year (i.e. increased in value/return). Although, such a stock could have made solid gains in its local currency, any gains arising from such stock value appreciation locally would be eroded if the local currency has decreased in value relative to Sterling (£). Therefore, the flexibility that derivatives in this instance affords investment managers as a tool for 'hedging' risk is critical to the effectiveness of investment strategy.
- 6.6 Managers need to be accountable for the entirety of their investment strategy and they need certain level of freedom to be able to do this. The conditions of investment agreed with investment managers set boundaries around how derivatives can be used and the funds investment managers are explicit in their policies on the use of derivatives as a tool for managing risk and enhancing portfolio efficiency.
- 6.7 The 5 mandates that currently use derivatives as part as part of an overall investment strategy are listed in the below table.

Manager's Name	Asset Class	Type of Fund
GMO	Global Equity	Non-pooled
Baillie Gifford	Global Equity	Pooled
Ruffer	Absolute Return	Pooled
Baillie Gifford	Absolute Return	Pooled
Investec	Global Bonds	Pooled

- 6.8 Finally, it is worth noting that the way that the funds investment managers use forward foreign exchange contracts ensures that any exposure to these instruments are limited to the margins in the contract to buy or sell a particular currency.
- 6.9 As an illustration of the low level of exposure to these financial instruments within the overall portfolio, all forward foreign exchange contracts would have resulted in a net increase of £740k in the value of fund assets worth nearly £500m as at 31 March 2010 were these assets to be realised. This equates to 0.0015% of the affected assets.

## **7. COMMENTS OF THE CHIEF FINANCIAL OFFICER**

- 7.1. The comments of the Corporate Director Resources have been incorporated into the report.

## **8. CONCURRENT REPORT OF THE ASSISTANT CHIEF EXECUTIVE (LEGAL)**

- 8.1 One of the functions of the Pensions Committee is to meet the Council's duties in respect of investment matters. It is appropriate, having regard to these matters, for the Committee to receive information about asset allocation and the preservation of Fund assets.
- 8.2 The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 require the Council, as an administering authority, to invest fund money that is not needed immediately to make payments from the Pensions Fund. The Council is required to have a policy in relation to its investments and a Statement of Investment Principles and to invest in accordance with these.
- 8.3 The Management and Investment of Funds Regulations specify that the term investment has its normal meaning. They also make clear that a contract entered into in the course of dealing in financial futures or traded options is an investment. The Regulations place percentage restrictions on types of investments, but these do not appear to relate to derivatives, with the exception that no single investment should exceed 10% of the fund. The percentage of the fund in derivatives is significantly below this.

## **9. ONE TOWER HAMLETS CONSIDERATIONS**

- 9.1 Any gains or losses arising from the use of derivatives contracts could impact on the Council through an increase or decrease in contributions in order to make good the Pension Fund's commitment to honour benefits that have been accrued by members of the Fund.
- 9.2 A viable pension scheme also represents an asset for the recruitment and retention of staff to deliver services to the residents.

## **10. SUSTAINABLE ACTION FOR A GREENER ENVIRONMENT**

- 10.1 There is no Sustainable Action for A Greener Environment implication arising from this report.

## **11. RISK MANAGEMENT IMPLICATIONS**

- 11.1 The use of any form of investment inevitably involves a degree of risk. Although, the use of derivative contracts is a means to reduce exposure to currency risk that the Fund.

## **12. CRIME AND DISORDER REDUCTION IMPLICATIONS**

- 12.1 There are no any crime and disorder reduction implications arising from this report.

## **13. EFFICIENCY STATEMENT**

- 13.1 The use of derivate contracts is an efficient use of financial instruments that helps to minimise risk to Pension Fund assets and also maximise returns.

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### **LOCAL GOVERNMENT ACT 1972 (AS AMENDED) SECTION 100D**

#### **LIST OF "BACKGROUND PAPERS" USED IN THE PREPARATION OF THIS REPORT**

*Brief description of "background papers"*

*Name and telephone number of holder  
And address where open to inspection*

