

Non-Executive Report of the: Pensions Committee 21 September 2017	
Report of: Zena Cooke, Corporate Director, Resources	Classification: Unrestricted
Pension Fund Annual Report with ISA 260 Report and Review of Fund Managers Internal Control Reports	

Originating Officer(s)	Bola Tobun, Investment and Treasury Manager
Wards affected	All wards

Summary

This report presents the final Pension Fund Annual Report for 2016/17 to Members. The draft version of the accounts was presented to the Committee in July 2017 together with the 2016/17 Audit Report of the Pension Fund (ISA 260 Report) following the audit by KPMG. The Statement of Accounts has been prepared under International Financial Reporting Standards (IFRS) rules and is now presented for consideration by the Pensions Committee.

This report also presents the finding of the review of the adequacy of internal control measures put in place by the fund managers that hold the Fund's assets. Officers and Advisers have reviewed the SAS70 and SSAE16 (which signifies that a service organisation has had its control objectives and control activities examined by an independent accounting and auditing firm).

The reviews of fund managers, internal control reports, have identified no significant changes in the internal control environment from last year.

The Fund managers' internal control reports have been audited and approved by external auditors and six out of the seven fund managers received unqualified opinion from their managers with the exception of Schroder. This means the auditors are satisfied that adequate controls are in place for managing and reporting of the Fund's assets.

Recommendations:

The Pensions Committee is recommended to:

- Note the contents of this report;
- Note the draft ISA 260 (Annex 2);
- Approve the Pension Fund Statement of Accounts (Appendix 5 of Annex 1);
- Approve the Pension Fund Annual Report and to give delegated authority to s151 to finalise and publish this in order to meet the

statutory publication deadline of 1 December 2017 (Annex 1);
and

- Approve publication and distribution to interested parties.

1. REASONS FOR THE DECISIONS

- 1.1 The Local Government Pension Scheme Regulations 2013, Regulation 53(2) states that 'An administering authority is responsible for managing and administering the Scheme in relation to any person for which it is the appropriate administering authority under these Regulations' and the internal audit report covered the area of how the Fund was being administered.
- 1.2 The Committee acts as quasi-trustee to the Pension Fund and as such acts in the capacity of the Administering Authority of the Pension Fund. The Committee's terms of reference require it to receive and approve an Annual Report and Accounts on the activities of the Fund prior to publication. The Local Government Pension Scheme Regulations 2013, Regulation 57 require the Pension Fund to publish this by 1st December following the financial year end and for the Report to contain a number of standard items.
- 1.3 The publication of the Pension Fund Annual Report and Statement of Accounts helps to keep Fund members informed, shows good governance and also helps to demonstrate effective management of Fund assets.
- 1.4 There are no alternative options in so far as the publication of the Statement of Accounts and Annual Reports is concerned because it is a legislative requirement. The review of fund managers' SAS 70 and SSAE 16 reports should provide assurance to the Pension Fund (Members and Trustees) that fund managers have adequate controls and safeguards in place for managing the Fund's assets. It is appropriate for the Committee and Fund members to be kept abreast of any risks identified through this process and the likely impact of such risks to the Fund.

2. ALTERNATIVE OPTION

- 2.1 There are no alternative options in so far as the publication of the Statement of Accounts and Annual Reports is concerned because it is a legislative requirement.

3. DETAILS OF REPORT

- 3.1 The Council as an administering authority under the Local Government Pension Scheme Regulations is required to produce a separate set of accounts for the scheme's financial activities and assets and liabilities.
- 3.2 The contents and format of the accounts are determined by statutory requirements and mandatory professional standards as established by the Chartered Institute of Public Finance (CIPFA) in their Service Code of Recommended Practice (SERCOP).

3.3 The London Borough of Tower Hamlets is the Administering Authority for the London Borough of Tower Hamlets' Pension Fund and the Pensions Committee act as trustees of the Pension Fund which includes overseeing the accounting and financial management of the Pension Fund.

3.4 KPMG is required to issue an ISA 260 report and opinion on the Council's accounts and this includes an opinion on the Pension Fund. This report sets out their opinions and any issues which they believe the Committee should be aware of.

3.5 At the time of writing this report, work on the audit of the Pension Fund accounts is substantially complete, subject to the completion of the auditor's final review and completion procedures. The auditor expects to issue an unqualified audit opinion on the Pension Fund and their comments are included within the attached draft ISA 260.

3.6 In summary the Annual Report comprises:

- a report on the management and financial performance of the fund during the year;
- an explanation of the investment policy;
- a report on the administrative arrangements for the fund;
- a statement from the actuary on the latest funding level;
- the current version of the governance compliance statement;
- the fund account and net asset statement with supporting notes and disclosures;
- the extent to which the fund has achieved its required performance levels; and
- the current version of the funding strategy statement, the statement of investment principles and communications policy and any other information the authority considers appropriate.

3.7 THE ANNUAL REPORT AND STATEMENT OF ACCOUNTS

3.7.1 The Accounts comprise two main statements with supporting notes. The main statements are:

- Dealings with Members Employers and Others which is essentially the funds revenue account; and
- The Net Assets Statement which can be considered as the funds balance sheet.

3.7.2 The return on investment section of the accounts sets out the movement in the net worth of the fund in the year by analysing the relevant financial transactions and movements in the market value of the investment portfolio. The statement has two main sections:

- The financial transactions relating to the administration of the fund;
and
- The transactions relating to its role as an investor.

- 3.7.3 Overall, fund assets had improved by £241.55m in the financial year. The improvement was due to the performance of the financial markets in which the Fund held its investments and a net gain between fund income and expenditure.
- 3.7.4 The net asset statement represents the net worth (£1,367m) of the Fund as at the 31st March 2017. The statement reflects how the transactions outlined in the other statement have impacted on the value of the Fund's assets.
- 3.7.5 The annual report also includes three key statements (Funding Strategy Statement, Investment Strategy Statement that replaced Statement of Investment Principles since April 2017 and Governance Policy and Compliance Statement) relating to the management and governance of the scheme and each statement serves a different purpose.
- 3.7.6 The Funding Strategy Statement (FSS) undergoes a detailed review and was updated after the triennial valuation. The 2016 triennial valuation outcome was reported, discussed and approved at the Pensions Committee meeting on 16th March 2017. The purpose of the Funding Strategy statement is threefold:
- To establish a clear and transparent fund specific strategy which will identify how employers' pension liabilities are best met going forward;
 - To support the regulatory framework to maintain as nearly constant employer contributions rates as possible; and
 - To take a prudent longer-term view of funding those liabilities.
- 3.7.7 The Investment Strategy Statement (ISS) replaced the Statement of Investment Principles from 1st April 2016. The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 require administering authorities to formulate and to publish a statement of its investment strategy, in accordance with guidance issued from time to time by the Secretary of State.
- 3.7.8 This ISS is designed to be a living document and is an important governance tool for the Fund. This document sets out the investment strategy of the Fund, provides transparency in relation to how the Fund investments are managed, acts as a risk register, and has been designed to be informative but reader focused. This document was discussed and approved at the Committee meeting of 16th March 2017 and is now due for another review as the Fund is currently undergoing a change of investment strategy.
- 3.7.9 The Governance Policy and Compliance Statement sets out the council's policy as the administering authority in relation to its governance responsibilities for the Fund. This policy has recently been reviewed for Committee discussion and approval at this meeting.
- 3.7.10 A new policy has been added to the annual report this year. This is The Risk Policy which sets out the risk management strategy of the Pension Fund covering its approach to risk, how it is managed and the procedures that are adopted as part of the risk management process.
- 3.7.11 The Policy sets out the aims and objectives for the management of risk, but also recognises that risk cannot be removed entirely from the management of the

Pension Fund, by the very nature of the Fund itself and the environment in which it operates. The risk management process involves the identification of risk, analysing risks, controlling risks where appropriate and the monitoring of risk on an ongoing basis.

- 3.7.12 The policy also sets out key internal controls identified and whilst this is not an exhaustive list, it forms the basis at a high level of some of the internal controls in place to manage the Fund on a day to day basis. The Public Service Pensions Act 2013 has added provisions from the 2004 Pensions Act for Public Service Schemes which means that it is essential to have internal control procedures for the purpose of ensuring that the scheme is administered in accordance with regulations and scheme rules. In addition The Pension Regulator (TPR's) Code of Practice guidance on internal controls requires scheme managers to carry out a risk assessment and produce a risk register which should be reviewed regularly. TPR also has powers to issue improvement notices where it is considered that the requirements relating to internal controls are not being adhered to.

3.8 Review of Fund Managers Internal Control Reports

- 3.8.1 These have been prepared under International Standards for Assurance Engagements (ISAE) 3402 issued by the International Auditing and Assurance Standards Board (IAASB) and the Audit and Assurance Faculty (AAF) 01/06 on assurance reports on the internal controls of service organisations made available to third parties, issued by the Institute of Chartered Accountants in England and Wales (ICAEW) or US equivalent. These reports are produced by the managers for clients and their auditors. An independent service auditor tests and opines of the control environment and its effectiveness is sample tested.
- 3.8.2 The control report sets out and describes the structure of each manager and its governance structure. It describes the control regimes including the responsibilities of the various committees and groups within them. The description is prepared to meet the needs of a broad range of clients and their independent auditors and may not therefore include every aspect of the process that an individual client and its auditors may consider important in its particular environment.
- 3.8.3 The independent service auditor role is to look at the "control environment", whether the controls meet the objective set by the manager and is what the auditor considers appropriate. It considers and tests to see if they have been applied consistently and effectively. Each service auditor observes that the managers are dependent on third party's (which they have not audited) control environments being adequate.
- 3.8.4 This authoritative guidance allows pension fund managers to disclose their control activities and processes in a universally recognised reporting format, which is updated annually.
- 3.8.5 The Fund has always required that fund managers prepare and provide their internal control reports as part of their reporting requirement to the Fund. These reports provide some assurance to the Fund that fund managers' internal controls and safeguarding measures are adequate. These reports are subject to annual audits, and consequently officers and advisers also review the updated

reports annually to ensure that any changes are acceptable to the Council and will not expose the Fund's assets to undue risk.

- 3.8.6 This financial year, the internal controls reports for the following fund managers have been received and reviewed:

Manager	Service auditor	Opinion
GSAM	PWC	Unqualified
Baillie Gifford	PWC	Unqualified
Schroder	PWC	Qualified (see below)
LGIM	PWC	Unqualified
GMO	PWC	Unqualified
Insight	KPMG	Unqualified
Ruffer	E & Y	Unqualified

- 3.8.7 The exceptions noted in the auditors' reports for these organisations have been considered for potential impact on the Pension Fund. Where there have been changes to procedures, officers and adviser have followed these up with the relevant managers to clarify impact on Fund assets. This process has not identified any significant change in risk to the Fund.

- 3.8.8 Each manager, with the exception of Schroder had an unqualified report which implies the control regime is both appropriate and working. It does not imply that each control test was passed and exceptions and the management's responses are set out below:

Schroder's internal control report was qualified because it "did not consistently provide evidence to demonstrate the independent review performed by authorised personnel of client reports for accuracy, completeness and compliance with client and portfolio requirements prior to dispatch." In other words the management could not prove to the service auditors that reports had been appropriately signed off, this is significant because clients rely on reports as a fair view of the fund's position hence performance etcetera. Schroder's response was "Management has performed a review to confirm that no errors were made in those client reports where the review was not evidenced. A process review was undertaken in January 2017 to identify the control enhancements required. An automated timestamp and enhanced audit trails were implemented so that the date on which the review was performed."

- 3.8.9 In addition to the provision of their internal control reports, two of the managers have provided audits of their UK Governance code. Both were unqualified. Please see exceptions noted as Annex 3 of this report.

- 3.9 Members are asked to delegate authority to the Corporate Director, Resource, following consultation with the Chair and Deputy Chair of the Pensions

Committee, to finalise and sign off the report. Members of the Committee will be sent a full copy of the report before publishing.

4. COMMENTS OF THE CHIEF FINANCE OFFICER

- 4.1 The Pension Fund Annual Report and Accounts sets out the financial position of the Pension Fund as at 31st March 2017 and as such acts as the basis for understanding the financial wellbeing of the Pension Fund. It also enables Members to manage and monitor the Scheme effectively and be able to take decisions understanding the financial implication of those decisions.
- 4.2 The performance of the separate audit has placed additional responsibilities on both the Fund and the Auditors and will help to ensure full compliance of the Administration Regulations.
- 4.3 The Pension Fund audit is being undertaken by KPMG and the audit fee has been maintained at £21,000.

5. LEGAL COMMENTS

- 5.1 The Council is an Administering Authority, as defined in Regulation 53 of the Local Government Pension Scheme Regulations 2013 (“the Regulations”). As such, it must maintain at least one fund for the Local Government Pension Scheme.
- 5.2 In accordance with Regulation 55 of the Regulations, a governance compliance statement must be produced, and published, and kept under review.
- 5.3 In accordance with Regulation 57 of the Regulations, a document known as the “pension fund annual report” must be produced each year. It must be published no later than 1 December following the Scheme year end.
- 5.4 In preparing and publishing the pension fund annual report, the authority must have regard to guidance given by the Secretary of State. The report should deal with the following matters:
 - a) management and financial performance during the year of the pension funds maintained by the authority;
 - b) an explanation of the investment policy for the fund and a review of performance;
 - c) a report on arrangements made during the year for administration of the fund;
 - d) a statement by an actuary who carried out the most recent valuation of the fund and the level of funding disclosed by that valuation;
 - e) a Governance Compliance Statement;
 - f) a Fund Account and Net Asset Statement with supporting notes and disclosures;
 - g) an Annual Report dealing with levels of performance set out in a pension administration strategy and any other appropriate matters arising from the strategy;
 - h) the Funding Strategy Statement;
 - i) the Investment Strategy Statement;

- j) statements of policy concerning communications with members and employing authorities; and
- k) any other material which the authority considers appropriate.

5.5 When performing its functions as administrator of the LBTH pension fund, the Council must have due regard to the need to eliminate unlawful conduct under the Equality Act 2010, the need to advance equality of opportunity and the need to foster good relations between persons who share a protected characteristic and those who don't (the public sector duty).

6. ONE TOWER HAMLETS CONSIDERATIONS

6.1 The Pension Fund Accounts demonstrate financial stewardship of the fund's assets. A financially viable and stable pension fund is a valuable recruitment and retention incentive for the Council.

6.2 A viable pension scheme also represents an asset for the recruitment and retention of staff to deliver services to the residents.

7. BEST VALUE (BV) IMPLICATIONS

7.1 The Pension Fund Annual Report and Accounts sets out the financial position of the Pension Fund as at 31st March 2017 and as such acts as the basis for understanding the financial wellbeing of the Pension Fund. It also enables Members to manage and monitor the Scheme effectively and be able to take decisions understanding the financial implication of those decisions

7.2 The review arrangement of fund managers' internal control provides some assurance to the Committee that assets are being managed in a way that is congruent with the Fund Strategy and therefore more likely to yield returns/outcomes that reflect Fund objectives.

8. SUSTAINABLE ACTION FOR A GREENER ENVIRONMENT

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

9. RISK MANAGEMENT IMPLICATION

9.1 Accounts provide an effective mechanism to safeguard the Council's assets and assess the risks associated with its activities.

9.2 The review of the SAS70/SSAE16 internal control reports of third parties that manage Pension Fund assets ensures that fund managers are able to demonstrate that they are properly managing pension fund assets as stewards of the Fund and are following procedures that do not expose fund assets to any undue risks.

9.3 Pension Fund assets could be exposed to undue risk where SAS70/SSAE16 reports are not in place or adequate internal controls and safeguard measures are lacking in the management of Fund assets.

10. CRIME AND DISORDER REDUCTION IMPLICATIONS

10.1 There are no any Crime and Disorder Reduction implications arising from this report.

Linked Reports, Appendices and Background Documents

Linked Report

- NONE

Appendices

- Annex 1 - 2016/17 Pension Fund Annual Report
- Annex 2 - 2016/17 KPMG Audit Report (ISA 260 Report)
- Annex 3 – Exceptions noted from FM Internal control review

Local Government Act, 1972 Section 100D (As amended)

List of “Background Papers” used in the preparation of this report

Fund Managers Internal Control Reports - (To be email if required)

- Schroders
- GMO
- Legal & General
- Goldman Sachs
- Insight
- Ruffer
- Baillie Gifford

Officer contact details for documents:

Bola Tobun(Investment & Treasury Manager) x4733

Annex C

Exceptions Noted from Fund managers Internal control Reports

1. GSAM – Exceptions noted

Control	Exception	Response
<p>11d. Individuals whose roles and responsibilities to infrastructure have changed as a result of a transfer event have their access privileges reviewed in a timely manner by appropriate personnel. Access is reapproved or revoked for individuals who no longer require access based on their new job functions.</p>	<p>For a sample of twenty-five (25) entitlements identified for removal as a result of a transfer event, one (1) entitlement was not removed.</p> <p>For the six hundred and forty-eight (648) entitlements identified as transfer events during the period October 1, 2015 to September 30, 2016:</p> <p>One (1) entitlement was not removed. □ Seven (7) entitlements were not removed in a timely manner.</p>	<p>During the period October 1, 2015 to September 30, 2016, eight (8) firm wide infrastructure access entitlements in total for one engineer in Technology Infrastructure were not removed in a timely fashion upon transfer to another role.</p> <p>The specific period that was impacted was between December 2015 and May 2016. The user's access to seven (7) firm wide infrastructure access entitlements was removed on March 5, 2016 and the remaining one (1) access entitlement was removed on May 16, 2016.</p> <p>In addition, management's review of aggregate performance of the control demonstrated over 98% performance effectiveness during the period October 1, 2015 to September 30, 2016.</p> <p>Additional measures are being implemented to prevent re-occurrence, including improving automatic fulfillment of privilege removal.</p>
<p>Infrastructure access privileges are re-</p>	<p>Exception noted in the revocation of access.</p>	<p>During the Q1 2016 recertification, one (1) access</p>

<p>certified on a periodic basis to ensure access is commensurate with the individual's current job role. Access is re-approved or revoked in a timely manner.</p>	<p>For a sample of sixteen (16) entitlements identified for removal as a result of the recertification, one (1) entitlement was not removed. For five hundred and seventy-two (572) entitlements identified for removal as a result of the recertification, one (1) entitlement was not removed.</p>	<p>entitlement for the same engineer in Technology Infrastructure as noted in control 11d was not removed in a timely fashion before the recertification completion date.</p> <p>The user's access to the one (1) access entitlement was removed on May 16, 2016.</p> <p>Additional measures are being implemented to prevent re-occurrence, including improving automatic fulfillment of privilege removal.</p>
<p>Backups to tape are monitored and failures are managed through to remediation.</p>	<p>For the period October 1, 2015 to December 31, 2015, the following exceptions were noted related to the population of backups to tape:</p> <p>50 month-end server backups across 35 unique servers were not written to tape media. For the 50 month-end server backups, a successful disk backup was performed.</p>	<p>The exception resulted from the misconfiguration of a new backup-to-disk system to provide faster backups and recovery. During the period October 1, 2015 to December 31, 2015, 50 month-end backups across 35 production servers were not copied to tape and as a result, a control incident was generated.</p> <p>The underlying technology issue that caused the control failure – misconfiguration of the disk to tape tier – was addressed in February 2016.</p> <p>For all servers across all months, at least one backup method (tape or disk to disk) succeeded; no data was at risk.</p> <p>Additional measures were implemented to prevent re-occurrence, including continuous monitoring of the disk-to-tape copy process; disabling automatic expiry of backups on disk; and verifying that disk-to-tape copies</p>

		complete before on-disk backups are deleted.
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2. Schroder – Exceptions noted

Apart from the qualification covered above no exceptions were noted.

3. Baillie Gifford – Exceptions noted (None)

4. LGIM – Exceptions noted

Control	Exception	Management response
<p>Investment strategy is set and implemented in a timely manner</p> <p>A Fund Objectives and Guidelines document (FOG) is created for each fund that summarises all of the investment guidelines and restrictions as part of the agreement. Each new FOG is reviewed and signed off by the Fund Manager, Client Account Manager and Portfolio Monitoring team</p>	<p>For a sample of 2 out of 26 new funds, the FOG document was not signed by a member of the Portfolio Monitoring team.</p>	<p>The control framework has been strengthened so that senior managers in the team now confirm that all FOGs documents are signed. This is evidenced in our Risk Management System</p>
<p>Investment strategy is set and implemented in a timely manner</p> <p>The majority of investment restrictions and guidelines are monitored through MIG21. These are input by a member of the Portfolio Monitoring</p>	<p>For a sample of 2 out of 26 new funds, the investment restrictions and guidelines were not released on MIG21 before the funds went live.</p>	<p>The control framework has been strengthened so that senior managers in the team now confirm that all FOGs documents are signed. This is evidenced in our Risk Management System</p>

<p>team and reviewed and released by a second person in the team before the fund goes live.</p>		
<p>Commission levels and transaction costs are monitored</p> <p>On a monthly basis, the heads of asset classes review a report of commission levels and turnover rates with the Head of Dealing. The final monthly report is prepared and shared with the Board and reviewed by the Board annually.</p>	<p>Due to software issues the monthly report was not ran for 3 months of the year. As such no meeting was held to discuss commission levels and turnover rates.</p>	<p>Steps have been taken to improve reliability of report generation and a subsequent review of the period in question showed that commission levels and turnover were within acceptable boundaries.</p>
<p>Logical access to computer systems programs, master data, transaction data and parameters, including access by administrators to applications, databases, systems and networks, is restricted to authorised individuals via information security tools and techniques.</p> <p>User access to IT network, infrastructure and applications is disabled on staff departure date and deleted after three months.</p>	<p>For 6 out of 162 leavers access was not appropriately disabled after they left LGIM.</p>	<p>To date, the process by which HR and IT are notified of leavers has been manual and relied on line managers notifying HR promptly. We are introducing a new control whereby the line manager will use Service Now to log leavers within LGIM will send automated report to HR and IT, which will then remove or disable systems access as well as making the individual a leaver. This will remove the manual element and the reliance on line managers which has cause the control to fail in the past. We expect this to be in place by end of Q2. No inappropriate access was achieved or attempted by the leavers.</p>

5. GMO– Exceptions noted

Control	Exception	Response
<p>For pooled products, the US or UK Operations team reviews a request to update existing account information and verifies it is instructed by an authorized signatory.</p> <p>Once reviewed, changes are made to GMO's client service database(s) (GPRS and/or Pivotal) by an appropriate Client Operations team representative in a timely manner. Updates to existing account information are compared and agreed by another Client Operations team representative against the request document.</p>	<p>US and UK Operational Controls Exception: For 1 of 40 client account update requests selected for testing, the client's request was not processed timely. PwC selected 24 additional client account update requests, and noted no additional exception</p>	<p>Management acknowledges the finding. Management has reinforced the importance of timely communication of client account changes to the Client Operations team for processing and performed additional training.</p>

6. Ruffer – Exceptions noted

Control	Exception	Management response
<p>Prices are regularly screened to a third party</p>	<p>In one instance of 25 no tolerance report could</p>	<p>We are confident that due procedure was followed and</p>

source and any result outside tolerance levels highlighted and reviewed	be obtained. In 2 instances, there was no evidence that the tolerance check had been investigated	that the failure was completed report evidencing... had not been saved correctly.... We are comfortable that the team completed... the control and this is an administrative error.
Any changes to user permissions (IT) are approved by internal authorized personnel	Noted that access to the Pulse system for one leaver (of 91) was not revoked after termination date.	We identified the leaver had been issued a second account due problems with application functionality. The second account was missed during the leaver process. The leaver process and review process has been reiterated to the relevant team.

7. Insight – Exceptions noted

Control	Exception	Management response
<p>Insight receives weekly status reports on timeliness and completeness of Client reporting from NT. The weekly status reports are monitored in the Client Administration FSM logged in the FSM action log.</p> <p>The monthly MI is reviewed at next Client administration FSM and outstanding issues escalated to the SMC</p>	For 4 out of 5 weeks no Client FSMs were held	The Client Administration FSM was not held for 6 months during the Head of Client Reporting's maternity leave. The acting Head of Client Reporting had daily interaction with NT in order to provide oversight of client reporting and resolution of issues. NT continued to produce MI which were circulated to relevant governance committees.

