Haringey Council

NOTICE OF MEETING

Pensions Committee

THURSDAY, 28TH JANUARY, 2010 at 19:00 HRS - CIVIC CENTRE, HIGH ROAD, WOOD GREEN, N22 8LE.

MEMBERS: Councillors C. Harris (Chair), Thompson (Vice-Chair), Beacham, Mallett, Wilson, Winskill and Cooke

IN ATTENDANCE: Howard Jones, Roger Melling, Earl Ramharacksingh and David Corran

AGENDA

1. **APOLOGIES FOR ABSENCE**

2. **URGENT BUSINESS**

   The Chair will consider the admission of any late items of urgent business. Late items will be considered under the agenda item where they appear. New items will be considered under agenda item 7 for unrestricted items and item 10 for exempt items of urgent business.

3. DECLARATIONS OF INTEREST

A member with a personal interest in a matter who attends a meeting of the authority at which the matter is considered must disclose to that meeting the existence and nature of that interest at the commencement of that consideration, or when the interest becomes apparent.

A member with a personal interest in a matter also has a prejudicial interest in that matter if the interest is one which a member of the public with knowledge of the relevant facts would reasonably regard as so significant that it is likely to prejudice the member's judgement of the public interest and if this interest affects their financial position or the financial position of a person or body as described in paragraph 8 of the Code of Conduct and/or if it relates to the determining of any approval, consent, license, permission or registration in relation to them or any person or body described in paragraph 8 of the Code of Conduct.

4. MINUTES (PAGES 1 - 8)

To confirm and sign the unrestricted minutes of the Pensions Committee meeting held on 1 December 2009.

5. GOVERNANCE OPTIONS REGARDING MONITORING OF FUND MANAGERS AND BUSINESS TIMETABLE FOR 2010/11 (PAGES 9 - 14)

Report of the Chief Financial Officer to present governance options regarding monitoring of Fund Managers and a Business Timetable for 2010/11.

6. SECURITIES LENDING (PAGES 15 - 22)

Report of the Chief Financial Officer to consider the introduction of securities lending programme in order to mitigate the overall costs associated with the provision of custodial services.

7. NEW ITEMS OF UNRESTRICTED URGENT BUSINESS

To consider any new items of urgent business admitted under agenda item 2.

8. EXCLUSION OF PRESS AND PUBLIC

The following item is likely to be subject of a motion to exclude the press and public from the meeting as it contains exempt information as defined in Section 100a of the Local Government Act 1972; namely information relating to the business or financial affairs of any particular person (including the Authority holding that information).

9. EXEMPT MINUTES (PAGES 23 - 24)

To confirm and sign the exempt minutes of the meeting of the Pensions Committee held on 1 December 2009.

10. NEW EXEMPT ITEMS OF URGENT BUSINESS

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Wednesday, 20 January 2010

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MINUTES OF THE PENSIONS COMMITTEE
TUESDAY, 1 DECEMBER 2009

Councillors	Thompson (Vice-Chair), Beacham, Mallett, Wilson, Winskill and Egan
Apologies	Cllr C. Harris and Earl Ramharacksingh
Also Present:	Howard Jones, Roger Melling and David Corran

MINUTE NO.	SUBJECT/DECISION	ACTION BY
PRPP128	**APOLOGIES FOR ABSENCE** Apologies for absence were received from the Chair, Cllr C. Harris, for whom Cllr Egan was acting as substitute, and from Earl Ramharacksingh. Cllr Thompson, Vice-Chair of the Committee, chaired the meeting.	
PRPP129	**URGENT BUSINESS** There were no items of urgent business.	
PRPP130	**DECLARATIONS OF INTEREST** Cllr Mallett declared a personal interest as a contributing member of the Haringey Pension Scheme. Cllr Wilson declared a personal interest as an employee of the National Association of Pensions Funds, and a prejudicial interest in respect of agenda item 12, the Custody Fee Review. Cllr Winskill declared a personal interest as a contributing member of the Haringey Pension Scheme. Cllr Thompson declared a personal interest as a contributing member of the Haringey Pension Scheme and as having attended training events at which he had received hospitality from some of the Fund Managers. David Corran declared an interest as a pensioner member of the Haringey Pension Scheme.	
PRPP131	**MINUTES** **RESOLVED** That the minutes of the meetings of the Pensions Committee held on 17 September and 12 October 2009 be approved and signed by the Chair.	

PRPP132 FUND ADMINISTRATION UPDATE

Ian Benson, Pensions Manager, presented the fund administration update. The report included information on the Heyday Judgement, in which the High Court had upheld the law allowing employers to force an employee to retire at 65 without redundancy, following a challenge by Age Concern. It was noted that a government review of the default retirement age had been brought forward to 2010. The report also covered the TUPE transfer of Learning Skills Council staff to Local Education Authorities, as part of which three staff would be transferred to Haringey, for which costs would be covered by a bulk transfer payment. Civil Service Scheme retirement dates for the staff affected would be protected in accordance with the Fair Deal provisions. An update was also provided on the Councillors Scheme to advise that the intended CLG consultation paper on councillors' pensions would be produced by the end of the financial year. The report also included updates on early and flexible retirements and appeals.

Further to an enquiry made by the Committee at the previous meeting, the Chair provided information on those scheduled and admitted bodies whose contributions had been received late by the Pension Fund.

The Committee noted that the earliest age at which an employee could be involuntarily retired would be raised from 50 to 55 from 1 April 2010, and asked whether there was any intention to make use of the intervening period to make any retirements from age 50. Mr Benson confirmed that there was no intention to do this. In response to a question from the Committee regarding the difference between flexible and early retirement, Mr Benson advised that early retirement was when an employee left their post, whereas flexible retirement meant that an employee remained in employment at reduced hours or at a lower grade, enabling the Council to retain their skills. The Committee asked about the employing bodies' ability to exercise discretion in determining the approval of early retirements, in response to which it was confirmed that any such decision by an employing body would require a contribution to the Fund to cover the capital costs, so that there was no cost to the Fund as a result of such decisions.

RESOLVED

That the Administration Report update be noted.

PRPP133 FUND PERFORMANCE REPORT

The Chief Financial Officer introduced the Fund Performance report for the quarter ending 30 September 2009. It was reported that the annualised performance of the Fund had underperformed the gross benchmark by 2.65% and underperformed the gross target by 4.29% up to 30 September 2009. The report covered the performance of the individual fund managers, responsible investment issues and the budget position.

	In response to concerns raised by the Committee regarding recent media reports relating to Shell, one of the Fund's main holdings, Colin Duck, Corporate Finance, advised that the information provided in the Fund Performance report only covered the period to September 2009 and that more recent activity would be reported to the next quarterly meeting. Mr Duck requested that Members supply him with details of any information of concern in relation to responsible investment issues, for forwarding to the Fund Managers in question for action. It was reported that such issues would also be highlighted by the LAPFF. The Committee emphasised the importance of responsible investment issues. **RESOLVED** i) That the Fund performance position as at end of September 2009 be noted. ii) The responsible investments information be noted. iii) That the budget monitoring position to the end of September 2009 be noted.	
PRPP134	**ATTENDANCE BY FUND MANAGERS** The Committee received presentations from two Fund Managers as follows: **PANTHEON** Pantheon presented information on the performance of the private equity mandate. Pantheon set out the position on current performance and answered questions from Trustees. The Committee asked about the apparent difference in the amount of funds drawn and the amount reported as allocated. It was reported that this was as a result of recent activity which would be reflected in the figures presented to the next meeting. In response to a question regarding the anticipated maximum net investment over time, Pantheon agreed to provide an estimate on the basis of the portfolio and it was agreed that the Committee would find this useful. In relation to the issue of responsible investment, the Committee asked whether Pantheon held a list of the companies they held stakes in. Pantheon advised that confidentiality agreements applied to certain companies they held, but agreed to provide a representative list in as great detail as possible on the request of the Committee. Pantheon reported that they were the first private equity manager to sign up to the UN Principles of Responsible Investment. It was requested that staffing issues be included in future reports to the Committee.	

	The Chair thanked Pantheon for their presentation. **CAPITAL** Fund performance for the equity mandate was 1.74% below the benchmark and 3.74% below the target in annualised terms in the 30-month period to the end of September 2009. Fund performance for the fixed income mandate was 1.03% below the benchmark and 2.03% below the target in annualised terms in the 30-month period to the end of September 2009. Capital explained the reasons for current performance and answered questions from Trustees. It was noted that the Committee had not been provided with revised versions of the performance information, and Capital agreed to supply these outside the meeting. The Chair thanked Capital for their presentation. **RESOLVED** That the presentations and answers to questions given by the Fund Managers be noted.	
PRPP135	**ANNUAL PENSION FUND REPORT FOR THE YEAR ENDED 31 MARCH 2009** The Chief Financial Officer presented the Annual Pension Fund Report for the year ended 31 March 2009, which formed part of the audit process now that the Pension Fund accounts were audited separately. The accounts presented in the annual report were the same as previously reported to the Committee and had now been signed off by the Auditors. The information contained within the report had been presented to the Committee at previous meetings, but there remained a further statutory requirement for the Annual Report to be presented for formal approval by the Committee, which was the purpose of this report. It was confirmed that this was a new requirement following from the separate audit of the Pension Fund accounts, and that a similar report would be produced on an annual basis. The Committee asked about the requirement for the Pension Fund to aim to be fully funded, and it was confirmed that this was a Government requirement under current regulations. The Chief Financial Officer reported that changes to this requirement were among the options being explored by CLG as a way of easing pressure on pension schemes. It was noted that there was a 20-year deficit recovery scheme in place for the Haringey Pension Fund, and that this would be reviewed in detail as part of the actuarial valuation process. The Committee enquired about the significance of the reference to the Council as a statutory body with tax raising powers, and it was confirmed that this was to differentiate from those bodies who only contributed to the scheme for a shorter period. The Committee asked what the position was in respect of the merger between CoNEL and Enfield College, and it was confirmed that	

	negotiations were ongoing between actuaries regarding the value of the transfer. As CoNEL was the larger of the two bodies, it was confirmed that current Enfield College members would be joining the Haringey Pension Scheme. In response to a request for clarification of the bullet points under the Basis of Preparation heading in the report, Mr Duck advised that the change from mid-market prices for investments to bid prices had had a negative impact on the Fund, and that as there had been no derivatives in the previous year, the impact of the change in the way these were valued was not yet known. It was clarified that figures relating to schools did not include teaching staff, who were part of a different Pension Scheme. **RESOLVED** That the Annual Pension Fund Report for the year ended 31 March 2009 be adopted.	
PRPP136	**QUARTERLY ASSET ALLOCATION REPORT** David Crum of Hewitt presented the quarterly asset allocation update. The Committee was reminded that the purpose of the report was for Hewitt to make recommendations on how to amend the asset allocation of the Fund in order to maximise performance, based on Hewitt's analysis of how the market was likely to change. This would enable the Committee to manage the asset allocation of the Fund on a more regular basis than the review of the investment strategy every three years. Further to the previous recommendation that a small percentage be moved from UK gilts to corporate bonds, it was reported that the Fund had benefited from this change by around £500k. Mr Crum reported that further to the production of the report, volatility in the market meant that Hewitt were no longer recommending any change in gilt holdings, but were still recommending a reduction in corporate bonds by around 2%. It was suggested that this be held in cash, for subsequent investment in property by the property manager. In response to a question from the Committee, Mr Crum reported that equities were considered on the basis of performance and company fundamentals rather than geographical location. The Committee asked the meaning of the phrase "overtaken reality" in relation to performance. Mr Crum advised that this referred to the belief in certain sectors that things were back to 'business as usual', and Hewitt's belief that this was over optimistic and not sustainable. The Committee asked why Hewitt were not recommending an increase in gilts, in response to which Mr Crum advised that this was as a result of the high price of gilts at the current time. In response to a question from the Committee regarding the impact of recent concerns relating to Dubai, Mr Crum reported that the extent of any impact would depend on the level of exposure of UK banks to Dubai holdings.	

	The Committee expressed concern regarding increasing the amount of the Fund held in cash, which was not earning significant interest at this time. Howard Jones, the Committee's Independent Advisor, reported that, at a recent meeting of the Committee, the Fund's property manager ING had been cautious regarding the outlook for investment in property, and asked whether Hewitt disagreed. Mr Crum responded that Hewitt did not fundamentally differ from this view. The Committee asked whether Hewitt would be making the same recommendations if it were known that ING were not going to draw on the money to invest, in response to which Mr Crum advised that Hewitt would still be likely to recommend a reduction in corporate bonds, which were overweight in the current allocation. The Chief Financial Officer suggested that ING be asked for their view on the likelihood of investment opportunities arising for which they would require funds. If they were confident that funds would be required, it was suggested that the recommendation to transfer 2% from corporate bonds to cash be acted on, otherwise the position would remain as at present. In respect of the overweight position in corporate bonds, it was suggested that this be monitored on a daily basis and that the Chief Financial Officer be authorised to take an urgent decision to reduce the allocation if this proved necessary, on the basis of an in-principle decision by the Committee. **RESOLVED** i) That an adjustment of 2% from corporate bonds to cash be made only if, following consultation with the Fund's property manager ING, there was felt to be a likelihood that opportunities for investment would arise. No change would be made in the event that ING advised that forthcoming opportunities for investment were unlikely. ii) That the Chief Financial Officer be authorised to make an urgent adjustment to corporate bonds as necessary, based on close monitoring of the performance of this asset class. iii) That the position be reviewed at the next meeting of the Committee.	
PRPP137	**NEW ITEMS OF URGENT BUSINESS** There were no new items of urgent business.	
PRPP138	**EXCLUSION OF PRESS AND PUBLIC** **RESOLVED** That the press and public be excluded from the meeting for the following item.	

PRPP139	**CUSTODY FEE REVIEW** Cllr Wilson declared a prejudicial interest and withdrew from the meeting for this item. Cllr Winskill also left the meeting. The Chief Financial Officer introduced the report on the custody fee review, and David Crum of Hewitt explained the content of the report in further detail and responded to questions from Trustees. **RESOLVED** i) That a revised custody tariff be agreed in order to achieve ongoing annual savings of approximately £25,000. ii) That a further report on the issue of securities lending be presented to the next meeting of the Committee.	
PRPP140	**NEW ITEMS OF EXEMPT URGENT BUSINESS** There were no new items of exempt urgent business. The meeting closed at 21:50hrs.	

COUNCILLOR CATHERINE HARRIS

Chair

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Haringey Council

Agenda Item

Pensions Committee On 28 January 2010

Report title: **Governance options regarding monitoring of Fund Managers and Business Timetable for 2010/11**	
Report of: **Chief Financial Officer**	
Ward(s) affected: All	**Report for**: Decision

1. Purpose

1.1 To present governance options regarding monitoring of Fund Managers and a business timetable for 2010/11

2. Recommendation

2.1 That the Committee consider the options presented and agree a business timetable for 2010/11.

Report authorised by: Gerald Almeroth – Chief Financial Officer

G. Almeroth

Contact officer: Colin Duck – Corporate Finance
Telephone 020 8489 37341

3. Executive Summary

3.1 The Committee are invited to consider the options presented concerning the monitoring of Fund Managers and the business timetable for 2010/11.

4. Head of Legal Services comments

4.1 The Head of Legal Services has been consulted on the content of this report. There is some discretion under the relevant statutory frameworks for Authorities to decide upon the specific structure and arrangements that they will adopt to for elected Members to carry out their legal responsibilities for the prudent and effective stewardship of the pension funds under their control. The arrangements and framework must however comply with the provisions of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998 and the statutory guidance covering governance compliance issued by the Secretary of State for Communities and Local Government and also fall within the best practice principles of that guidance and the principles of investment practice within LGPS schemes adopted by CIPFA (The "Myners Principles"). Each of the options set out for consideration in the appendix to the report falls within the statutory framework and best practice principles indicated.

4.2 The Authority is under a duty to publish and to keep under review a governance compliance statement by virtue of Regulation 31 of the Local Government Pension Scheme (Administration) Regulations 2008. Material changes to the current statement including the delegation of functions, frequency of meetings and representation should be published and a copy sent to the Secretary of State. In doing so the Authority must consult such persons as it considers appropriate.

5. Local Government (Access to Information) Act 1985

The following background papers were used in the preparation of this report:

Report by Hewitt to Pensions Committee in October 2008.

6. Background

6.1 The purpose of this report is to consider the best practice options regarding the monitoring of the performance of our Fund Managers and agree a business timetable for 2010/11.

6.2 LGPS regulations require that:

- The investment manager must report to the administering authority at least once every three months on the action taken for them;

- Where an administering authority has appointed an investment manager they must keep their performance under review;
- At least once every three months the administering authority must review the investments investment managers have made;
- Periodically an administering authority must consider whether or not to retain each investment manager;
- In reviewing an investment manager's decisions and appointment, an administering authority must take proper advice.

6.3 It is important for the Committee to have the best balance between time spent reviewing investment strategy and monitoring Fund Managers. In the long run, investment strategy adds most value and is an area of significant importance specifically mentioned in the Myners Principles.

6.4 Currently Pensions Committee meets six times per annum (excluding any special meetings). At four of these meetings Fund Managers attend and two meetings are for other business. Our core Fund Managers (Capital International and Fidelity) attend Pensions Committee quarterly to present their performance and set out their longer term strategies. Our other managers with longer term investments attend annually (ING and Pantheon). Legal & General who passively invest the portfolio formerly managed by Bernstein attend as requested. Currently each fund manager attends Committee for 25 to 30 minutes as the meetings have limited time available.

6.5 The Officers and the Independent Advisor to Trustees meet with our Fund Managers every three months to review performance other than our private equity manager where meetings are held every six months.

7. Options

At the Pensions Committee meeting in October 2008, consideration was given to a report from the Council's external investment advisors Hewitts on best practice options.

7.1 Three best practice options, different from the current arrangements, were identified and are as follows;

1. Refocus of current structure: The Committee continues to hold six meetings per annum but with three dedicated to business and three dedicated to Fund Manager monitoring. In addition the agenda would be more focussed – with more emphasis and time spent on the Fund's investment strategy and monitoring at a Fund level;
2. Use of a Sub Committee: The Committee could delegate some responsibilities to a Sub Committee. This body could either be a standing body or meet when deemed necessary. Elected Members who sit on the Pensions Committee could attend the Sub Committee at any time;
3. Delegating responsibilities to Officers: The Committee could create an

Investment Advisory Panel, to deal with some of the Fund's investment matters. Membership of the Panel could include Officers, Independent Advisor and Investment consultants. Pensions Committee members could attend at any time. The Panel would support the Committee, possibly to include developing investment strategy, monitoring investment managers, monitoring investment management agreements and guidelines, and overseeing the rebalancing of the Fund's strategy. Final decisions would be made by Pensions Committee and the latter could meet less often to quarterly.

7.2 Following consideration of Hewitts' report it was felt that OPTION 1 represented the best way forward. The core fund managers would attend twice per annum but with an option of attending more frequently if performance became unsatisfactory. Our other fund managers could attend annually with all being seen at a third meeting. This would then leave three meetings of the Committee available for other matters including reviewing asset allocation and overall investment strategy. However, as there was unprecedented turbulence in financial markets at that time Members agreed that no changes be made to the current arrangements and the matter be reviewed at a future date. The Business timetable (attached as Appendix I) indicates that there is a considerable additional volume of business to be considered by the Committee in the coming year. This additional business is concerned principally with the actuarial valuation as at 31st March 2010 and a full review of the current investment strategy which may result in a number of recommendations to change the current investment management arrangements.

CONCLUSIONS

In order to accommodate the additional business in the coming twelve months, and to maintain robust monitoring arrangements it is proposed that Capital (whose performance continues to cause concern) attend the April meeting, Capital and Fidelity the September meeting, and both core managers (Capital and Fidelity) and the long term managers (Pantheon and ING) at the January 2011 meeting.

The Officers and the Independent Advisor would continue to hold quarterly performance meetings, with Capital International, Fidelity and ING, and a bi-annual meeting with the private equity manager, Pantheon.

8. Recommendation

8.1 That the Committee consider the options presented and agree to adopt the pensions business timetable set out as Appendix I.

APPENDIX I

PENSIONS BUSINESS TIMETABLE- 12 MONTHS COMMENCING 15/04/2010

Pensions Committee 15/04/2010	**Pensions Committee June 2010**	**Pensions AGM July 2010**	**Pensions Committee September 2010**	**Pensions Committee October 2010**	**Pensions Committee December 2010**	**Pensions Committee January 2011**
Quarterly Asset Allocation Review-Hewitts	Business Plan 22010/11 including SIP	Guest Speaker	Quarterly Asset Allocation Review - Hewitts	Quarterly Asset Allocation Review - Hewitts	Quarterly Asset Allocation Review-Hewitts	Attendance of Fund Managers-Capital, Fidelity, ING and Pantheon
Capital to attend	Full Review of Investment Strategy (1)	Annual Report 2009/10	Capital and Fidelity to attend	Full Review of Investment Strategy (2)		
	Actuarial Valuation-demographic and statistical assumptions	Pension Fund Accounts for y/e 31/03/2010		Actuarial Valuation – initial indications of 2010 valuation	Final Results of Actuarial Valuation 2010	
Fund Performance Report	Fund Performance Report	Ballot for pensioner representative	Fund Performance Report	Fund Performance Report		
Fund Administration Update	Fund Administration Update		Fund Administration Update		Fund Administration Update	
Report on Pension Fund Bank Account	Pension Fund Financial Statements for y/e31/03/2010, Audit Plan and Budget 2010/11		Annual Governance Plan-statutory report of Grant Thornton			

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Haringey Council

Agenda item:

Pensions Committee	On 28 January 2010

Report Title. **Securities Lending**

Report of **Chief Financial Officer**

Signed :

Contact Officer : **Colin Duck - Corporate Finance**
Telephone 020 8489 3731

Wards(s) affected: **All**	Report for: **Non key decision**

1. Purpose of the report

1.1. To consider the introduction of securities lending programme in order to mitigate the overall costs associated with the provision of custodial services.

2. Introduction by Cabinet Member

2.1 Not applicable.

3. State link(s) with Council Plan Priorities and actions and /or other Strategies:

3.1 Not applicable

4. Recommendations

4.1. That Members give full consideration to the introduction of a securities lending programme in order to mitigate the overall costs of custody provision.

5. **Reason for recommendation(s)**
5.1. To reduce the costs of custody provision.

6. **Other options considered**
6.1. None

7. **Summary**

7.1. Hewitt's recommend that consideration be given to the introduction of a securities lending programme which could result in annual income accruing to the Pension Fund in the region of £64,000 to £108,000 thereby eliminating the current costs of custody.

8. **Head of Legal Services Comments**
8.1. The Head of Legal Services has been consulted on the content of this report and comments that, in considering the recommendations set out in this report, the Committee should give full consideration to the financial advice received concerning the introduction of a securities lending programme. In giving consideration to this matter the Committee must bear in mind its duty to take into account the interests of stakeholders and beneficiaries of the Pension Fund. Members may also wish to consider the implications of the communication from Cllr Ian Greenwood at Appendix 2 in the light of the Committee's policies on investment.

9. **Equalities &Community Cohesion Comments**
9.1. Not applicable

10. **Consultation**
10.1 Not applicable

11. **Use of appendices**
11.1. Appendix 1 –Report of Hewitts dated 16 November 2009
11.2. Appendix 2 – Communication from Cllr Ian Greenwood, Chair of the Local Authority Pensions Fund Forum

12. **Background**

12.1. At the last meeting, consideration was given to Hewitts recommendation that the Council adopt a securities lending programme. Hewitts estimate that the Pension Fund could earn between £64,000 and £108,000 p.a. from this activity thereby eliminating the current costs of custody which are estimated by Hewitts to be approximately £86,000 p.a. Hewitts proposals are re-circulated as Appendix 1 to this report.

12.2. Members expressed some concerns at the proposals and it was resolved that: "a report on securities lending, including the extent of local authority participation and the risks involved, be presented at the next meeting of the Committee".

13. **Local Authority Participation in Securities Lending**

13.1. Of the 33 London Pensions Authorities (32 London Boroughs and the London Pension Fund Authority), 7 authorities currently operate a securities lending programme. Anecdotal evidence suggests that the majority of non participants are either concerned at the perceived risks associated with the process or dislike the connotation to 'short selling' and other forms of market manipulation. In this latter connection, I attach a communication from Councillor Ian Greenwood, Chair of Local Authority Pensions Fund Forum as Appendix 2 in which he expresses some concern in respect of the role of stock lending in the ongoing Kraft bid for Cadbury.

14. **The Risks and Safeguards Involved in Securities Lending**

14.1. In the UK stock lending is supervised by the Financial Services Authority whilst HMRC monitors it for tax purposes. In the view of CIPFA (Guide to Stock Lending by Local Authority Pension Funds), this degree of regulation makes it a relatively low-risk market in which to lend. However, as securities lending is a commercial activity within financial markets, there is an inevitable degree of risk. In the attached report, Hewitts have highlighted three main risks, which are:

- Collateral risk – that the collateral received against the lent asset is insufficient to cover the repurchase of the asset in the event of a borrower default;
- Counterparty risk – that there is a problem with the party that borrows the assets (e.g. the collapse of Lehman Brothers, who were active as a counterparty in the securities lending marketplace); and
- Cash re-investment risk – any cash accredited as collateral has to be re-invested to provide the lender with a rebate when the cash is returned.

Hewitts proposals to obviate these risks are to ensure that the securities lending agreement stipulate that:

- The collateral remains at 105% of the value of the lent asset and will be maintained at that level and;
- Collateral be held in non-cash form i.e. Government Bonds, Certificates of Deposit, Equities and Commercial paper. In addition, as an additonal safeguard, an indemnity could be obtained from the custodian whereby Northern Trust would make up any shortfall between the collateral and lent asset in the event of borrower default. However Hewitts point out that 'this insurance comes at a price'.

15. **Conclusion**

15.1 The management of the above risks identified by Hewitts, namely maintaining collateral at 105% of the value of assets lent and holding collateral in non-cash form is consistent with the safeguards proposed by CIPFA. Whilst there are a number of ways to manage and mitigate risks of loss in terms of securities lending it is a permitted activity for local authority pension funds. Nevertheless, I recommend that given the concerns around the implications concerning 'short selling' and other forms of market manipulation and the relatively small savings associated therewith, that the Pension Fund does not lend stock at the present time.

Appendix A – Securities Lending

Proposal from NT on securities lending

We stated that we had asked NT to look at the assets held on behalf of the Fund, and to provide an estimate on what kind of revenue might be generated if the Fund chose to participate in their Securities Lending programme. We set out below what securities lending it, why we believe it is an important activity, what the LGPS Investment Regulations have to say on lending, the risks involved and our views on its suitability for pension fund clients.

What is securities lending?

At its simplest level, securities lending is an activity where the beneficial owner of an asset lends it to a borrower. In return, the lender receives a fee for lending the asset. Collateral is received from the borrower, which is held as security against the lent asset. If the borrower were to 'default' i.e. to not return the lent asset – then the collateral would be sold off, and the proceeds from the sale used to buy an equivalent holding of the asset that was originally loaned.

The most popular way of participating in securities lending as an activity is for pension funds' custodian to manage the process on their behalf on an agency basis. They include the funds' assets in their lending programmes, matching lenders and borrowers, and managing the collateral. They can also offer indemnities against problems relating to collateral held in certain circumstances. In return, the custodian takes a share of the revenue generated by the lending activity

Securities lending & liquid markets

Securities lending plays an important part in helping to maintain liquid markets. Maintaining a liquid securities market is in the interest of pension funds – particularly in periods of intense market turmoil – as we now explain.

Market liquidity requires market makers to quote buying and selling prices in considerable size and on a narrow spread; their willingness to do so would diminish rapidly without access to borrowed securities in order to cover the short position that results automatically whenever their selling price is accepted. Without an ability to borrow, they would be forced to cover positions immediately at another trader's offered price, and therefore, - to protect themselves against the risk of loss - would widen the bid/offer spread and reduce the size of order for which their quote is good.

Therefore, it would become progressively more difficult to trade large positions without moving the price and pension fund investment performance would inevitably suffer as a result. Goldman Sachs recently published a research note on the short selling ban in the US, and the effect it had on the spreads of the stocks concerned. The report concluded that '...during the short-sell ban, quoted spreads on the short-sell ban stocks widened relative to other stocks'.

Securities lending and voting

One of the main concerns which we regularly come across when discussing securities lending with clients relates to voting. Most of our LGPS clients are actively involved in voting on the asset that they own, and worry that this kind of shareholder engagement might be impacted by lending.

Our advice is to simply instruct the custodian that they have to recall any stock that is out on loan to allow for all votes to be cast in a timely manner. This is something that any good custodian can simply build into the lending arrangements of their clients.

This may have a small impact on potential revenue earned, but clearly is worth the effort to ensure that votes continue to be cast on behalf of the Fund.

LGPS Investment Regulations

Securities lending is a permitted activity under the Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998. The Regulations relating to lending were last amended in 2001, when securities lending was defined as an investment conforming to the rules 5.14.4R and 5.14.6R of the Financial Services Authority Collective Investment Schemes (CIS) Sourcebook. The CIS rules ceased to apply after February 2007, when the CIS sourcebook was replaced with the New Collective Investment Scheme Sourcebook (COLL).

At the moment, we are awaiting revised LGPS Investment Regulations, following the recent consultation exercise undertaken by the Department for Communities and Local Government. From the draft Regulations that were issued as part of the consultation, there has been no change to the original position of securities lending being a permitted activity.

The LGPS Investment Regulations also state that the maximum amount of securities transferred by the authority under securities lending arrangements is 35%, although in practice we have found clients tend to have – at most – somewhere between 10-15% of lendable assets on loan at any given time.

Securities lending in the press

Financial markets endured unprecedented volatility during the initial stages of the credit crunch in 2008. Amongst many high profile events that occurred – in addition to the failure of Lehman Brothers - one of the more obvious was the collapse of the share prices of the large British banks, most noticeably HBoS.

During the initial stages of the collapse, much noise was made in the press on 'short selling' – and therefore through implication, securities lending. The public perception was that speculators had driven down the price of HBoS through borrowing securities and selling them – hoping to buy them back at a lower price and to therefore bank a profit.

Analysis on activity in the securities lending market undertaken by DataExplorers at the time did not indicate that there was any unusual lending activity generated around HBoS shares. They did not fall because they were being short sold – but instead fell because sentiment turned increasingly negative against Financials, and arguably 'long only' institutional investors began selling down their own holdings. This analysis is supported by the fact that the share prices of the large British banks continued to fall after the FSA brought in specific restrictions prohibiting the short selling of shares of certain Financial companies, including these banks.

Therefore, we would argue that 'spivs and speculators' targeted in the media were not the main cause of the collapse in the HBoS share price. They may well have played some part, but were not primarily responsible.

The risks involved in lending

No investment activity is without risk of some sort, and securities lending is no different. There are essentially three main risks:

- collateral risk – that the collateral received against the lent asset is insufficient to cover the repurchase of the asset in the event of a borrower default;
- counterparty risk – that there is a problem with the party that borrowed the assets (e.g. the collapse of Lehman brothers, who were active as a counterparty in the securities lending marketplace); and
- cash reinvestment risk – any cash accepted as collateral has to be reinvested to provide the lender with a rebate when the cash is returned to them

These risk are deal with in a number of ways:

1) Collateral held is 'marked to market' on a daily basis – that is, the value of the collateral held is compared to the value of the asset lent every day, and an adjustment is made where necessary, asking for more collateral from the borrower, or indeed returning excess collateral. The custodian will tend to operate a policy where the collateral has a 'haircut' – in effect, non cash collateral received will be 105% of the value of the lent asset, and will be maintained at that level.
2) Counterpart risk is effectively dealt with by means of the collateral. As was the case with Lehmans, when they went into liquidation and ceased trading, they

were declared in default by the custodians to whom they had lent assets. In this case, the collateral held was liquidated and the proceeds used to buy back the asset that had been borrowed, and which now could not be returned.

3) Our view of the best way to avoid the cash collateral reinvestment risk is to simply not take cash collateral. In our experience, this has little impact on the revenue to be earned from lending. Alternatively, for clients who are comfortable accepting cash collateral, it can be stipulated that it can only be reinvested in Government Bonds, thereby reducing the reinvestment risk.

4) As mentioned earlier, custodians also offer indemnities to clients in their lending programmes. What this means is that they will effectively make up any shortfall in the difference between the collateral and the lent asset in the event of a borrower default. This 'insurance' comes at a price, but may well be worth considering for clients who have a very cautious approach to lending.

NT's approach to collateral

As stated above, one of the key risks relating to lending is the deciding what kind of collateral is acceptable. There are essentially two kinds of collateral:

- cash – such as US Dollars, Sterling, Euros
- non-cash – such as Government Bonds, Certificates of Deposit, Equities, Commercial Paper

Problems arose in the lending industry last year relating to cash collateral. When a lender accepts cash collateral from a borrower, there is an expectation that when the cash is returned to the borrower it will have been invested in the intervening period to generate a return – the 'rebate'.

The problems encountered in the last year stemmed from the fact that several of the large custodians reinvested cash collateral in assets such as Asset Backed and Mortgage Backed Securities. As the credit crunch unfolded, these assets became extremely illiquid and fell in value. This presented a problem when cash collateral had to be returned to borrowers.

NT currently operates a pooled approach to collateral, whereby clients decide which of the available pools they wish to use as part of their lending programme. They currently run two collateral pools – one for cash, and one for non cash. Should the Fund decide to participate in securities lending with NT, we would recommend that only non-cash collateral is acceptable.

We are also aware that NT are exploring the possibility of creating additional collateral pools, which will be limited to more stable forms of collateral, such as only Government Bonds.

Should the Committee decide to explore securities lending further, we would be happy to discuss this issue of acceptable collateral further in due course.

Hewitt's View on Securities Lending

We believe that securities lending is a valuable, revenue generating activity for clients – albeit with some risks. Aside from the additional revenue it generates for lenders, it also helps to ensure a liquid securities market by providing market makers with the opportunity to borrow assets to settle transactions.

Conclusion

In our view, securities lending is an entirely suitable practice for pension schemes as long as the risks are understood and controlled. Recent events have not altered our advice.

APPENDIX 2

Dear Colleagues

As you will no doubt have been reading in the financial press the market for corporate control – otherwise known as M&A (mergers and acquisitions) - is beginning to hot up.

There are several potential deals under consideration in the UK market, both hostile and friendly, as well as various shareholder challenges to incumbent management taking place.

I have asked PIRC to prepare a note on these matters for consideration at a future Forum Executive meeting but I would like to draw your immediate attention to a particular and very important aspect of this market trend and that is the implication of such activity for your stock lending programmes.

Perhaps the most important hostile takeover proposal currently being considered is the Kraft bid for Cadbury. The press have reported on the build up of hedge fund positions in Cadbury. These positions are typically derived from so called "borrowed stock".

I would like to advise all LAPF Forum member funds to ask their lending agent if any Cadbury stock is included amongst their lent stock and to confirm the mechanism for recalling Cadbury stock in order to vote the shares at any forthcoming shareholder meeting associated with the Kraft bid. In addition you will no doubt be aware that your fund's shares could be held by a manager in their custody account or in a pooled vehicle. Such arrangements are not of course through a traditional lending agent and funds may wish to consider requesting where possible the withdrawal from lending their shares or challenge how the manager proposes to act if this is not possible.

Also where external managers are used funds may wish to question how their managers' propose to balance potential conflicts between short term performance gains against long term shareholder interests. In addition, those funds where governance arrangements, in particular proxy voting, are outsourced may also wish to question how their 3rd party proxy research advisers intend to deal with any potential bid affecting their shareholder rights, in both Kraft and Cadbury.

The Forum Executive has to date not considered the current bid from Kraft for Cadbury although I know of several Forum funds that are doing so.

If in subsequent weeks the Executive decides to issue a LAPFF Alert on the matter I shall write to you again on the matter.

With best regards for the New Year

Cllr Ian Greenwood

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