

GOVERNANCE ARRANGEMENTS FOR THE PENSION FUND

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SUMMARY

This report recommends that the operating framework of the Investment Sub-Committee (ISC) of the Pension Fund be changed to allow it to be better able to respond to the challenges it faces in respect of delivering improved stewardship of market and manager risks. Following a review of the operation of the Investment Sub Committee and an increasing need for calling urgent Pension Committee meetings, a change to the terms of reference of the ISC, to include increased delegated authority, is being recommended.

RECOMMENDATION: That the terms of reference of the Investment Strategy Sub-Committee be amended to include the authority for it to reallocate assets and/or generate market exposure using established financial instruments up to 10% of Scheme assets, subject to the conditions outlined in the body of the report.

Reasons for recommendation

Hillingdon has created an appropriate structure through the ISC for better managing Fund assets, However, it has the potential to add further value over time if it is given some delegated authority, rather than having to refer every decision back to a quarterly Pensions Committee.

Alternative options considered / risk management

The alternative option, to leave the operating framework unchanged, could have the potential to increase the risk of loss of pension fund value through the inability to take urgent investment decisions when required.

INFORMATION

There is a general acceptance that a local government pension scheme cannot usefully evolve under a structure based around quarterly committee meetings. Within the world of investment, highly structured meetings are often an impediment to the effective evolution of the Fund's asset mix although they are ideal for executing effective governance. Accordingly, ISC structures are being created within most councils.

Usually and correctly, the aim is to delegate to the ISC investment matters of a market/manager nature while morphing the main Pensions Committee into a much more focused governance Board including exercising oversight on the ISC.

Summary of Initial Operations

The Hillingdon ISC has been operating for approximately one year. The current framework requires formal 'sign-off' from Pensions Committee before action can be taken. The ISC is thus an entity charged with idea generation, design and review. Despite the focus of the group, it has no flexibility to act.

The meetings held have been conducted around a pre-set agenda supported by detailed inputs from advisors but the discussion is allowed to evolve naturally, invariably to productive effect. The deployment of scheme assets across the global financial markets is always reviewed and the ISC has been instrumental in initiating appropriate changes. These have included:

- instigation of a glacial currency hedging programme – removing, perhaps most significantly, the direct impact of any rapid deterioration in the euro;
- the switch of assets away from an underperforming manager ahead of the recent market turmoil; and
- managing the redesign of the global bond portfolio.

In each of the above, one of the major motives has been to reduce balance sheet risk without compromising prospects for generating long term return, which is essential if contribution rates are to be kept stable. In addition, the ISC has sought to adopt a truly long-term perspective and has commissioned appropriate research from Hymans Robertson for assessment at future meetings.

Lessons Learned

1. The current structure works due to the commitment and insights of the participants, the flexible nature of the meetings and the preparedness of the individuals involved to act.
2. The market generates challenges and opportunities of a nature and frequency that may often require a degree of action that the current operating framework does not permit. This is sub-optimal. Increased delegation of powers under a strict governance structure is appropriate to enhance but, more importantly, to defend Scheme value.

Evolving the Framework

The opportunity cost involved in returning ISC recommendations to Pensions Committee for approval prior to implementation can be considerable. By way of illustration, the ISC resolved at its most recent meeting to recommend a switch of assets away from hedge funds and for a period, investing the monies in bond markets. This was based on an assessment of the limited scope for near term returns from a fund of hedge funds and the favourable characteristics of bonds in any sharp market sell-off, which was judged likely. In the event, equity markets have fallen and bond values have risen. If the ISC had been free to commence implementation of the initiative the Fund would have enjoyed gains of around 5% on the bond exposures involved. This illustrates the potential benefit of granting the ISC an element of discretionary freedom within certain parameters.

Proposed Structure

Ideally all investment activity should be conducted within a set of guidelines calibrated according to risk relative to liabilities. Although the ISC aspires to create such a framework, it isn't yet available. Accordingly, any discretionary freedom granted to the ISC should be bounded according to percentage exposure. This report recommends that the ISC be permitted to reallocate assets and/or generate market exposure using established financial instruments up to 10% of Scheme assets.

Conditions:

1. All action should be supported by a detailed description of the activity, its impact and potential risks as well as the potential pre-conditions for reversal; this should be communicated to the Chief Finance Officer prior to implementation.
2. The activity be justified by members of the ISC and reviewed at the next Pensions Committee meeting.
3. Regular reporting on the subsequent performance of the action taken should be presented to Pensions Committee.
4. No action which the Pensions Committee could not immediately reverse may be implemented in this manner.

In general terms, issues surrounding specific managers and markets, outside of extreme situations, should not be the ongoing focus of Pensions Committee. Exercising the appropriate level of governance is becoming important for pension funds and requires a different set of skills and focus from investment management.

Aside from general oversight the Pensions Committee should demand and receive detailed reporting from the ISC. It should ensure that the inputs and operations of the ISC comply with the clear objectives set for it.

FINANCIAL IMPLICATIONS

The financial implications are contained within the body of the report.

LEGAL IMPLICATIONS

The establishment of the Investment Strategy Sub-Committee was approved by full Council which also agreed its terms of reference. Therefore, further approval from full Council is required in order to change the terms of reference by giving the Sub-Committee delegated power to reallocate assets and/or generate market exposure using established financial instruments up to 10% of Pension Scheme Assets, subject to the four specific conditions identified in the body of the report.

BACKGROUND DOCUMENTS: None