ITEM 8

NORTH YORKSHIRE COUNTY COUNCIL

PENSION FUND COMMITTEE

23 FEBRUARY 2017

GOVERNANCE ARRANGEMENTS

Report of the Treasurer

1.0 **PURPOSE OF REPORT**

1.1 To seek Committee approval of the new Investment Strategy Statement

1.2 To present to the Committee the finding of the Independent Professional Observer on the Fund's governance arrangements

2.0 **INVESTMENT STRATEGY STATEMENT**

2.1 To remind Members, the LGPS (Investment and Management of Funds) Regulations 2016 came into force on 1 November 2016, replacing the 2009 Regulations. A new requirement of these Regulations is that administering authorities are required to maintain and publish an Investment Strategy Statement (ISS) no later than 1 April 2017. This requirement replaces the previous requirement to maintain a Statement of Investment Principles (SIP).

2.2 The purposes of the SIP and the ISS are very similar, being the provision of evidence that administering authorities have considered the suitability of their Fund's investment strategy and the approach to implementing that strategy.

2.3 Due to the limited time available to prepare the ISS it has not been possible to share the document with Members until now. As the Regulations require that an approved ISS be published no later than 1 April 2017, this meeting is therefore the only opportunity to seek approval. Members are therefore asked to approve the ISS, subject to any amendments they may wish to make.

2.4 The ISS, attached as **Appendix 1**, has been prepared in accordance with DCLG's "Guidance on Preparing and Maintaining an Investment Strategy Statement" document, attached as **Appendix 2**. This guidance supports the Regulations and goes into some detail about what the ISS should cover. Part 2 of the guidance describes the component parts to be included in the ISS, which are:

1. Investment of money in a wide variety of investments
2. The suitability of particular investments and types of investments
3. The approach to risk, including the ways in which risks are to be measured and managed
4. The approach to pooling investments, including the use of collective investment vehicles and shared services
5. How social, environmental or corporate governance considerations are taken into account in the selection, non-selection, retention and realisation of investments
6. The exercise of rights (including voting rights) attaching to investments

2.5 The guidance for each section includes a summary of requirements identifying the key points the ISS is expected to address. Each section of the ISS with the exception of the approach to pooling investments is based on the Fund's SIP, updated to meet these requirements. The section on pooling is necessarily brief, as the detailed arrangements including the range and characteristics of sub-funds as well as the reporting arrangements to each Pension Fund Committee are still to be worked through. Future iterations of the ISS will include more details as pooling develops.

2.6 The Independent Professional Observer was asked to comment on the ISS. He made a number of observations, particularly in relation to pooling investments and policies which may change through coordinating the approach with partner Funds within Border to Coast Pensions Partnership.

2.7 Specifically, points were made on:

- Setting out the proportion of assets that will be invested through pooling
- Summarising assets that would not be suitable for pooling
- Considering the views of interested parties when making investments decisions based on non-financial factors
- Explaining the approach to social investments
- Reporting on voting activity in the Annual Report
- Statement on investments in entities connected to the Administering Authority
- Statement on persons consulted in relation to the ISS

2.8 The Fund's approach to these issues will become clearer either as pooling arrangements develop or as examples of best practice emerge. Recognising that the ISS is a fluid document, it is anticipated that amendments will be required in due course. The intention is therefore to bring an updated ISS to this Committee for approval at the 6 July 2017 meeting.

3.0 GOVERNANCE COMPLIANCE UPDATE – REPORT OF THE INDEPENDENT PROFESSIONAL OBSERVER

3.1 The remit of the Independent Professional Observer, Peter Scales, is to provide advisory services on governance and compliance to the Committee. To this purpose, he has conducted a review of these arrangements as they operated during each financial year and has made a number of recommendations. Peter will be attending the PFC meeting on 23 February 2017 to present his report.

3.2 This latest report (attached as **Appendix 3**) provides an update of his review of the current governance compliance arrangements for the Fund, and comments on the implementation of pooling arrangements.

3.3 The high governance standards of the fund are described as being maintained and improved, however attention is drawn to regulatory changes as well as changes in the guidance issued by DCLG, tPR and CIPFA which will require careful consideration. The importance of reviewing governance arrangements during the implementation of pooling has also been highlighted.

3.4 There are two specific recommendations in the report.

1. That strategy and policy documents and governance arrangements are kept under review as the new pooling arrangements are finalised and the process of implementation moves forward

2. That the Pension Board works with the Committee and officers to both check and ensure compliance with new regulations and guidance issued over the past six months

3.5 Officers will review arrangements with regard to point 1 and will keep Members updated through future PFC Meetings. Officers will also discuss point 2 with the Chair of the Pension Board with a view to this being added to the Board's work programme.

3.6 A final draft of the FSS was received from Aon on the 17 February 2017 and therefore was not available for review, however it is not anticipated that there will be any issues with either the document's compliance with legislative requirements or its content.

4.0 RECOMMENDATIONS

4.1 Subject to any changes agreed at the meeting, Members approve the Investment Strategy Statement in **Appendix 1**.

4.2 Members note the report of the Independent Professional Observer in **Appendix 3**.

GARY FIELDING
Treasurer
Corporate Director – Strategic Resources
County Hall
Northallerton

14 February 2017

NORTH YORKSHIRE PENSION FUND

INVESTMENT STRATEGY STATEMENT

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1.0 INTRODUCTION

1.1 Regulation 7 of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 (the Regulations) requires administering authorities to formulate, publish and maintain an Investment Strategy Statement (ISS). This document is the ISS of the North Yorkshire Pension Fund (NYPF, or the Fund) for which North Yorkshire County Council (the Council) is the administering authority.

1.2 The Council has delegated all its functions as the administering authority of NYPF to the Pension Fund Committee (PFC, or the Committee). The Corporate Director - Strategic Resources, who reports to the Chief Executive, has day to day control of the management of all aspects of the Fund's activities.

1.3 The Committee determines the investment policy of the Fund and has ultimate responsibility for the investment strategy. The Committee undertakes its responsibilities after taking appropriate advice from external advisers.

1.4 The Committee seeks to invest in accordance with the ISS, any Fund money that is not needed immediately to make payments from the Fund. The ISS should be read in conjunction with the Fund's Funding Strategy Statement.

2.0 OBJECTIVES OF THE FUND

2.1 The primary objective of the Fund is to provide pension benefits for members upon retirement and/or benefits on death for their dependents, on a defined benefits basis. Investments will therefore be selected with the aim of fully funding these benefit requirements over an extended number of years. The funding position will be reviewed at each Triennial Valuation with adjustments to the investment strategy, asset allocation and to investments with investment managers as required.

2.2 The investment objective of the Fund is to provide for sufficient capital growth of the Fund's assets in a range of market conditions, supplemented by employee and employer contribution income, to meet the cost of benefits as they fall due. It is translated into a suitable strategic asset allocation benchmark designed to address the nature of the Fund's liabilities, and deliver returns over the long term including through periods of volatility in financial markets.

3.0 INVESTMENT OF MONEY IN A WIDE VARIETY OF INVESTMENTS

3.1 The Committee reviews the investments of the Fund on a regular basis. The last review of the investment strategy took place in 2013 and there is an ongoing review of the strategy, alongside the 2016 Triennial Valuation, due to be completed in 2017. Additional reviews of individual asset classes have also taken place, with particular regard to diversification and suitability. The Committee receives advice from its Investment Consultant when undertaking such reviews.

3.2 These reviews provide a framework designed to produce the returns the Fund requires over the long term to meet its future liabilities. Each asset class invested in is allocated a range, and rebalancing takes place when values stray beyond them due to market conditions. Further rebalancing may take place based on tactical views of the Fund's advisers.

3.3 The Fund's current strategic asset allocation is set out below. The table also includes the ranges within which the asset allocation may vary without specific reference to the Committee, however in practice the allocation is considered by the Committee each quarter and adjustments made as necessary.

	Minimum %	Benchmark %	Maximum %
Equities	50	62	75
Alternatives	10	20	20
Fixed Income	15	18	30

3.4 The largest proportion of the Fund's investments are in equities which is aimed at growing the value of assets over the long term. Other return seeking asset classes complement this goal, with the allocation to liability matching assets providing a measure of protection against rising liability valuations.

3.5 Each asset class is sub-divided into two or more mandates with different investment managers and operating to different benchmarks, further increasing the diversification of the Fund's investments.

3.6 The most recent changes to the strategy have been the addition of Alternatives, being Property (2012), Diversified Growth Funds (2013) and Private Debt (2016). These asset classes have served to further diversify the Fund's investments, spreading risk and reducing short term volatility.

3.7 Each investment manager operates to a specific benchmark and to specific mandate restrictions appropriate to their process and style, so that in aggregate, their activities are aligned to the overall performance requirements and risk appetite of the Fund. Each manager holds a range of underlying investments which reflects their views relative to their respective benchmarks, as permitted by their mandates.

3.8 The investment management arrangements of the Fund are as follows.

Manager	**Mandate**	**Objective**
Standard Life	UK Equities	To outperform the FSTE 350 (excluding Investment Trusts) Equally Weighted Index by 3% pa over the long term
Baillie Gifford	Global Equities (Global Alpha)	To outperform the FTSE All World Index by 2% over the long term
Baillie Gifford	Global Equities (Long Term Global Growth)	To outperform the FTSE All World Index by 3% over the long term
Dodge & Cox	Global Equities	To outperform the MSCI All Country World Index over a market cycle
Veritas	Global Equities	To outperform CPI + 6% to 10% over the medium term
Fidelity	Overseas Equities	To outperform an MSCI geographically weighted index by 2% pa over the medium term
Newton	Diversified Growth Fund	To outperform LIBOR by 4% over the medium term
Standard Life	Diversified Growth Fund	To outperform LIBOR by 5% over the medium term
Hermes	UK Property	To outperform the IPD Other Balanced Property Funds Index by 0.5% over the medium term
Legal & General	UK Property	To outperform the IPD All Balanced

		Property Funds Index over the medium term
Threadneedle	UK Property	To outperform the IPD All Balanced Property Funds Index by 1% to 1.5% over the medium term
M&G	UK Government Bonds	To outperform liabilities by 0.5%
ECM	European Corporate Bonds	To outperform LIBOR by 3%
BlueBay	Private Debt	
Permira	Private Debt	

4.0 THE SUITABILITY OF PARTICULAR INVESTMENTS AND TYPES OF INVESTMENTS

4.1 The following categories of investment have been approved as suitable for the NYPF.

UK Equities provide a share in the assets and profitability of public companies floated on UK stock exchanges. Capital gains and losses arise as share prices change to reflect investor expectations at the market, sector and stock levels. Income is derived from dividends.

Overseas Equities are similar to UK Equities but allow greater diversification amongst markets, sectors and stocks. Valuations are affected by exposure to movements in the relative value of the foreign currencies in which investments are made against sterling. Exchange rates are likely to reflect differentials in inflation so should not affect returns materially over the long term, but over the short term currency movements may significantly add to or subtract from returns. Equities are expected to provide high returns compared to other asset classes (the “equity-risk premium”); to address the NYPF deficit position a high proportion of assets will be held in equities.

UK Bonds are debt instruments issued by the UK Government and other borrowers. Bonds provide a fixed rate of interest and are usually redeemed at a fixed price on a known future date. Valuations primarily reflect the fixed level of interest, the period to redemption and the overall return demanded by investors. They are vulnerable to rising inflation and correspondingly benefit from falling inflation.

Overseas Bonds are similar to UK Bonds but have exposure to currency exchange rate fluctuations. As with UK bonds they are influenced by local inflation rates.

Index Linked Bonds are bonds that provide interest and a redemption value directly linked to a measure of inflation, usually the Retail Price Index or a similar index. The returns from this asset class act as a useful proxy for movements in liability values.

Diversified Growth Funds are an alternative way of investing in shares, bonds, property and other asset classes. These funds are managed by specialist multi-asset managers and target returns slightly

	below that of equities but with significantly reduced volatility due to the diversification of their constituent parts.
UK Property	is an investment in buildings, indirectly through pooled vehicles. Capital gains and losses occur as prices fluctuate in line with rental levels and investor demand. Income is generated from rents collected from tenants. The nature of rental agreements gives property some of the characteristics of bonds, whilst growth and inflation provide some of the characteristics of equities. It is, therefore, a useful diversifying asset class.
Private Debt	is loan arrangements provided directly to companies over the medium term for an index linked return, significantly above rates charged by commercial banks. Typically they are provided through pooled fund arrangements and require that investors commit funds for a period of 5 to 7 years, with income and capital being returned throughout that time.
Derivative Instruments	such as options and futures are mechanisms through which the Fund can be protected from sudden changes in share prices or exchange rates. Although not income producing they can result in capital gains and losses. They may be used to hedge the Fund's exposure to particular markets.
Cash	is invested in authorised institutions in accordance with the treasury management policy of the Council under the terms of a Service Level Agreement and attracts interest at market rates.

4,2 Each asset class has different return expectations and volatility characteristics. They are blended to produce the optimal investment return while taking an appropriate level of risk. Periodic investment reviews assess whether this blend requires adjustment, including through the addition of new asset classes, to take account of changing market conditions and the evolving asset and liability profile of the Fund. Tactical rebalancing also takes place, as required. All monitoring, reviews and rebalancing is undertaken after taking advice from the Fund's Investment Consultant.

4.3 The 2016 Triennial Valuation was prepared on the basis of an expected real return on assets of 3% over the long term, being a nominal return of 5% assuming CPI inflation to be 2%. This is based on the Fund's current asset mix and assumes no outperformance from active management.

5.0 THE APPROACH TO RISK, INCLUDING THE WAYS IN WHICH RISKS ARE TO BE MEASURED AND MANAGED

5.1 The Fund to aims to achieve its funding objective by taking an appropriate level of risk, through investing a proportion of funds in growth assets. Ongoing monitoring of the risk profile takes place including reassessing its appropriateness through investment strategy reviews and at the quarterly meetings of the PFC when appropriate. Close regard is paid to the ongoing risks which may arise through a developing mismatch, over time, between the assets of the Fund and its liabilities, together with the risks which may arise from any lack of balance/ diversification of the investment of those assets.

5.2 The risk of financial mismatch is that the Fund's assets fail to grow in line with the liabilities. It is managed by the Committee through a review of the assumptions used to calculate the Fund's liabilities at each Triennial Valuation, and an assessment by the Actuary of the Fund's asset allocation strategy of the probability of achieving funding success. This assessment forms the basis for subsequent asset allocation reviews aimed at controlling risk and further improving the funding position.

5.3 Longevity risk and other demographic factors are assessed at each Triennial Valuation. The Committee reviews national and Fund specific trends as part of this process.

5.4 Systemic risk, being the possibility that an event akin to the financial crisis occurs, is mitigated through the diversified nature of the Fund's asset allocation strategy. The Committee has taken steps since 2008 to spread investments across a larger number of asset classes which behave differently in different market conditions. The risks associated with individual asset classes, the combined nature of risks at Fund level are reassessed at each strategy review and changes made as appropriate.

5.5 This diversification across asset classes and across investment managers within each asset class significantly mitigates concentration risk, so that the effect of underperformance of any one asset class or investment manager is minimised. Rebalancing activity prevents departure from the strategic asset allocation benchmark.

5.6 The significant majority of the Fund's assets are invested in liquid investments, so that the risk of illiquidity, being an inability to meet liabilities as a result of a lack of liquid assets, is minimal. The risk is further managed by cashflow forecasting.

5.7 Currency risk is that the Fund's assets, the majority of which are overseas, underperform relative to Sterling. This risk is managed through a periodic assessment of currency exchange rates including receiving advice on the suitability of hedging the major currencies the Fund's assets are denominated in.

5.8 Agreements with the Fund's custodian and investment managers provide protection against fraudulent losses. In addition regular checks are undertaken by independent auditors of the custodian's and investment managers' systems. These organisations have internal compliance teams which also monitor and report on risk.

5.9 The Fund maintains a Risk Register which identifies the key risks, an assessment of the potential impact of each risk should it occur, and the controls and contingency plans in place to mitigate the likelihood and severity of each risk. The Risk Register is reviewed by the PFC annually and by the Pension Board semi-annually.

6.0 THE APPROACH TO POOLING INVESTMENTS, INCLUDING THE USE OF COLLECTIVE INVESTMENT VEHICLES AND SHARED SERVICES

6.1 The Fund is a member of the Border to Coast Pensions Partnership ("BCPP", or "the Pool"). The proposed structure and basis on which the BCPP will operate was set out in the July 2016 submission to Government.

6.2 The key criteria for the assessment of the Pool are that it provides a suitable solution that meets the investment objectives and asset allocation strategy of the Fund and that there is significant financial benefit to joining the arrangements.

6.3 The change in arrangements is that the Pool will be responsible for manager selection and monitoring, which is currently a responsibility of the Committee. The responsibilities for determining the investment strategy and asset allocation strategy will remain with the Committee.

6.4 At the time of preparing this statement the details of the pooling arrangements are being finalised. However it is expected that NYPF's liquid assets will be transitioned into the Pool once suitable sub-funds are in place, and that illiquid investments will be retained by NYPF. New investments will be made through the Pool wherever possible.

6.5 The July 2016 submission to Government of BCPP provided a statement addressing the structure and governance of the Pool, the mechanisms by which the Fund can hold the Pool to account and the services that will be shared or jointly procured. Government approved this approach on 12 December 2016. The Fund has been working with the BCPP to progress arrangements on this basis.

6.6 Arrangements include establishing a Financial Conduct Authority regulated company to manage the assets of BCPP partner Funds. Based on legal advice describing the options on holding shares in this company, BCPP Limited, the Fund will hold all voting and non-voting shares rather than the Council. This is because the purpose of the company is to meet the needs of the BCPP Funds in complying with the regulations on pooling, rather than for a Council specific purpose.

6.7 The Fund will hold the Pool to account through having a representative on the Joint Committee, which as an investor will monitor and oversee the investment operations of BCPP Limited. It will also have a representative on the Shareholder Board, which will as an owner provide oversight and control of the corporate operations of BCPP Limited.

6.8 As the Pool develops and the structure and governance of the Pool are established, the Fund will include this information in future iterations of the ISS.

7.0 HOW SOCIAL, ENVIRONMENTAL OR CORPORATE GOVERNANCE CONSIDERATIONS ARE TAKEN INTO ACCOUNT IN THE SELECTION, NON-SELECTION, RETENTION AND REALISATION OF INVESTMENTS

7.1 The PFC takes the view that its overriding obligation is to act in the best financial interests of the Scheme and its beneficiaries. It is recognised that environmental, social and governance ("ESG") factors can influence long term investment performance and the ability to achieve long term sustainable returns. Therefore, as a responsible investor, the Committee wishes to promote corporate social responsibility, good practice and improved performance amongst all companies in which it invests.

7.2 The Committee considers the financial impact of ESG factors on its investments through regular reporting by the Fund's investment managers. Engagement with company management and voting behaviour are integral to investment processes aimed at improving performance in companies in which they invest.

7.3 As well as delegating the Fund's approach to ESG issues to its investment managers, NYPF is also a member of the Local Authority Pension Fund Forum (LAPFF) which is the UK's leading collaborative shareholder engagement group. This organisation promotes ESG good practice on behalf of over 70 LGPS funds. Its activity acts as a complement to that undertaken by the Fund's investment managers. Any differences in approach are discussed with the Fund's investment managers so that the reasons are fully understood.

7.4 The Fund is compliant with the six principles on investment decision making for occupational pension schemes, as set out in the guidance published by the Chartered Institute of Public Finance and Accountancy in December 2009 called "Investment Decision Making and Disclosure in the Local Government Pension Scheme: A Guide to the Application of the Myners Principles".

8.0 THE EXERCISE OF RIGHTS (INCLUDING VOTING RIGHTS) ATTACHING TO INVESTMENTS

8.1 The Committee has delegated the exercise of voting rights to Pension Investment Research Consultants Limited (PIRC). Votes are executed by PIRC according to predetermined Shareholder Voting Guidelines agreed by the PFC, available on the Fund's website www.nypf.org.uk. These guidelines are aligned to the UK Stewardship Code and to best practice in other jurisdictions. Votes are cast for all UK equities held by the Fund, and for non-UK holdings where practicable. The Fund monitors voting decisions on a regular basis.

8.*2* The Fund adheres to the Stewardship Code as published by the Financial Reporting Council. The Committee will expect both BCPP Ltd and any investment managers appointed by it to also comply with the Stewardship Code.

8.3 The Fund's collective engagement activity through the LAPFF supports the voting activity undertaken by PIRC.

8.4 The Fund aims to adopt the Principles of the Financial Reporting Council's UK Stewardship Code. A Statement of Compliance will be published on the Fund's website in 2017.

23 February 2017

Appendix 2

Department for Communities and Local Government

Local Government Pension Scheme

Guidance on Preparing and Maintaining an Investment Strategy Statement

September 2016
Department for Communities and Local Government

This document/publication is also available on our website at www.gov.uk/dclg

If you have any enquiries regarding this document/publication, complete the form at http://forms.communities.gov.uk/ or write to us at:

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Foreword

This guidance has been prepared to assist administering authorities in the local government pension scheme in England and Wales with the formulation, publication and maintenance of their Investment Strategy Statement.

New investment regulationsto be introduced later this year will include a requirement for administering authorities to publish new Investment Strategy Statements by 1st April 2017 in accordance with the guidance set out below.

Administering authorities will be required to act in accordance with the provisions in this guidance when Regulation 7 of the Local Govenrment Pension Scheme (Management and Investment of Funds) Regulations 2016 comes into force.

Part 1

Introduction and background

This guidance has been prepared to assist administering authorities in the formulation, publication and maintenance of their Investment Strategy Statement required by Regulation 7 of The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016. Unless otherwise stated, references to regulations are to the 2016 Regulations.

An administering authority's duty to prepare, maintain and review their Funding Strategy Statement under Regulation 58 of the Local Government Pension Scheme Regulations 2013 ("the 2013 Regulations") is unaffected.

Statutory background

Regulation 7(1) requires an administering authority to formulate an investment strategy which must be in accordance with guidance issued by the Secretary of State.

The Investment Strategy Statement required by Regulation 7 must include:-

a) A requirement to invest money in a wide variety of investments;
b) The authority's assessment of the suitability of particular investments and types of investments;
c) The authority's approach to risk, including the ways in which risks are to be measured and managed;
d) The authority's approach to pooling investments, including the use of collective investment vehicles and shared services;
e) The authority's policy on how social, environmental or corporate governance considerations are taken into account in the selection, non-selection, retention and realisation of investments; and

f) The authority's policy on the exercise of rights (including voting rights) attaching to investments.

The Investment Strategy Statement must also set out the maximum percentage of the total value of all investments of fund money that it will invest in particular investments or classes of investment. This, in effect, replaces Schedule 1 to the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 ("the 2009 Regulations").

Under Regulation 7(6) and (7), the statements must be published by 1st April 2017 and then kept under review and revised from time to time and at least every three years. Under transitional arrangements, key elements of the 2009 Regulations relating to investment policies will continue in force until such time that the Investment Strategy Statement under Regulation 7 is published.

Directions by the Secretary of State

Regulation 8 enables the Secretary of State to issue a Direction if he is satisfied that an administering authority is failing to act in accordance with this guidance.

One of the main aims of the new investment regulations is to transfer investment decisions and their consideration more fully to administering authorities within a new prudential framework. Administering authorities will therefore be responsible for setting their policy on asset allocation, risk and diversity, amongst other things. In relaxing the regulatory framework for scheme investments, administering authorities will be expected to make their investment decisions within a prudential framework with less central prescription. It is important therefore that the regulations include a safeguard to ensure that this less prescriptive approach is used appropriately and in the best long term interests of scheme beneficiaries and taxpayers.

Where there is evidence to suggest that an authority is acting unreasonably, it may be appropriate for the Secretary of State to consider intervention, but only where this is justified and where the relevant parties have been consulted. Regulation 8 includes a number of safeguards, including full consultation with the relevant authority, to ensure that the proposed power is used appropriately, proportionately and only where justified by the evidence.

The Secretary of State's power of intervention does not interfere with the duty of elected members under general public law principles to make investment decisions in the best long-term interest of scheme beneficiaries and taxpayers.

The power of Direction can be used in all or any of the following ways:-

a) To require an administering authority to make changes to its investment strategy in a given timescale;
b) To require an administering authority to invest assets as specified in the Direction;
c) To transfer the investment functions of an administering authority to the Secretary of State or a person nominated by the Secretary of State; and

d) To require an administering authority to comply with any instructions from either the Secretary of State or the appointed person in circumstances when the investment function has been transferred.

Before issuing any Direction, the Secretary of State must consult the administering authority concerned and before reaching a decision, must have regard to all relevant evidence including reports under section 13(4) of the Public Service Pensions Act 2013; reports from the scheme advisory board or from the relevant local pension board and any representations made in response to the consultation with the relevant administering authority. The Secretary of State also has the power to commission any other evidence or additional information that is considered necessary.

General

Part 2 below sets out the guidance for authorities under each of the component parts of Regulation 7. The specific requirements under each heading are shown at the end of each sub section in a text box and in bold type. It is important to note, however, that these lists are not exclusive and that administering authorities are also required to comply with general public law principles and act within a prudential framework.

Part 2

Regulation 7(2) (a) - Investment of money in a wide variety of investments

A properly diversified portfolio of assets should include a range of asset classes to help reduce overall portfolio risk. If a single investment class is not performing well, performance should be balanced by other investments which are doing better at that time. A diversified portfolio also helps to reduce volatility.

For example, the range of asset classes could include UK and overseas equities of different sectors; bonds with varying maturity; alternative investment assets such as private equity, infrastructure and cash instruments.

However, this guidance does not purport to prescribe the specific asset classes over which fund monies must be diversified. This remains a decision for individual administering authorities to make. Administering authorities are expected to be able to demonstrate that those responsible for making investment decisions have taken and acted on proper advice and that diversification decisions have been taken in the best long term interest of scheme beneficiaries.

An administering authority must also be able to demonstrate that they review their diversification policy from time to time to ensure that their overall target return is not put at risk.

Summary of requirements

In formulating and maintaining their policy on diversification, administering authorities:-

- **Must take proper advice**

- **Must set out clearly the balance between different types of investments**
- **Must identify the risks associated with their overall investment strategy**
- **Must periodically review their policy to mitigate against any such risks**

Regulation 7(2)(b) - The suitability of particular investments and types of investments

The concept of suitability is a critical test for whether or not a particular investment should be made. Although individual investment classes will have varying degrees of suitability in the context of an authority's funding and investment strategies, the overall aim of the fund must be to consider suitability against the need to meet pension obligations as they fall due.

Assessing the suitability of different investment classes involves a number of factors including, for example, performance benchmarks, appetite for risk, policy on non-financial factors and perhaps most importantly, funding strategy.

What constitutes suitability is clearly a matter for individual administering authorities to consider and decide in the light of their own funding and investment strategies, but there is a clear expectation that the assessment should be broadly consistent across all administering authorities. Administering authorities must therefore take and act on proper advice in assessing the suitability of their investment portfolio and give full details of that assessment in their Investment Strategy Statement.

Summary of requirements

In formulating their policy on the suitability of particular investments and types of investments, administering authorities:-

- **Must take proper advice**
- **Should ensure that their policy on asset allocation is compatible with achieving their locally determined solvency target**
- **Must periodically review the suitability of their investment portfolio to ensure that returns, risk and volatility are all appropriately managed and are consistent with their overall investment strategy**

Regulation 7(2)(c) - The approach to risk, including the ways in which risks are to be measured and managed

The appetite of individual administering authorities for taking risk when making investment decisions can only be a matter for local consideration and determination, subject to the aim and purpose of a pension fund to maximise the returns from investment returns within reasonable risk parameters.

Some of the key risks that an administering authority needs to be aware include financial, demographic or regulatory risks. A detailed summary of the identification of all risks and counter-measures to mitigate against them is beyond the scope of this guidance, but administering authorities will continue to have regard to the requirement under Regulation

58 of the 2013 Regulations to have regard to the “Guidance on Preparing and Maintaining a Funding Strategy Statement” published by CIPFA, which includes a section on risk and the ways in which it can be measured and managed.

Summary of requirements

In formulating their policy on their approach to risk, administering authorities:-

- **Must take proper advice**
- **Should clearly state their appetite for risk**
- **Should be aware of the risks that may impact on their overall funding and investment strategies**
- **Should take measures to counter those risks**
- **Should periodically review the assumptions on which their investment strategy is based**
- **Should formulate contingency plans to limit the impact of risks that might materialise**

Regulation 7(2)(d) - The approach to pooling investments, including the use of collective investment vehicles and shared services

All authorities must commit to a suitable pool to achieve benefits of scale. Administering authorities must confirm their chosen investment pool meets the investment reform and criteria published in November 2015, or to the extent that it does not, that Government is content for it to continue.

Any change which results in failure to meet the criteria must be reported by the administering authority, and/or pool, to the Secretary of State and the Scheme Advisory Board.

Administering authorities should set out their approach to pooling and the proportion of assets that will be invested through the pool. This must include the structure and governance arrangements and the mechanisms by which the authority can hold the pool to account.

Where services are shared or jointly procured, the administering authority must set out the rationale underpinning this and the cost benefit of this, as opposed to pooling.

Administering authorities must provide a summary of assets to be held outside of the pool, and how this demonstrates value for money. The progress of asset transfers to the pool must be reported annually against implementation plans and submitted to the Scheme Advisory Board. Where it is possible that an asset could be pooled in the future, authorities must set a date for review and criteria that need to be met before the asset will be pooled.

Summary of requirements

In formulating and maintaining their approach to pooling investment, including the use of collective investment vehicles and shared services, an administering authority must:-

- **Confirm the pooling arrangements meet the criteria set out in the November 2015 investment reform and criteria guidance at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/479925/criteria_and_guidance_for_investment_reform.pdf, or have been otherwise agreed by the Government**
- **Notify the Scheme Advisory Board and the Secretary of State of any changes which result in failure to meet the criteria**
- **Set out the proportion of assets that will be invested through pooling**
- **Set out the structure and governance arrangements of the pool and the mechanisms by which the authority can hold the pool to account**
- **Set out the services that will be shared or jointly procured**
- **Provide a summary of assets that the authority has determined are not suitable for investing through the pool along with its rationale for doing so, and how this demonstrates value for money;**
- **Regularly review any assets, and no less than every 3 years, that the authority has previously determined should be held outside of the pool, ensuring this continues to demonstrate value for money**
- **Submit an annual report on the progress of asset transfers to the Scheme Advisory Board**

Regulation 7(2)(e) - How social, environmental or corporate governance considerations are taken into account in the selection, non-selection, retention and realisation of investments

When making investment decisions, administering authorities must take proper advice and act prudently. In the context of the local government pension scheme, a prudent approach to investment can be described as a duty to discharge statutory responsibilities with care, skill, prudence and diligence. This approach is the standard that those responsible for making investment decisions must operate.

Although administering authorities are not subject to trust law, those responsible for making investment decisions must comply with general legal principles governing the administration of scheme investments. They must also act in accordance with ordinary public law principles, in particular, the ordinary public law of reasonableness. They risk challenge if a decision they make is so unreasonable that no person acting reasonably could have made it.
The law is generally clear that schemes should consider any factors that are financially material to the performance of their investments, including social, environmental and

corporate governance factors, and over the long term, dependent on the time horizon over which their liabilities arise.

However, the Government has made clear that using pension policies to pursue boycotts, divestment and sanctions against foreign nations and UK defence industries are inappropriate, other than where formal legal sanctions, embargoes and restrictions have been put in place by the Government.

Although schemes should make the pursuit of a financial return their predominant concern, they may also take purely non-financial considerations into account provided that doing so would not involve significant risk of financial detriment to the scheme and where they have good reason to think that scheme members would support their decision.

Investments that deliver social impact as well as a financial return are often described as “social investments”. In some cases, the social impact is simply in addition to the financial return; for these investments the positive social impact will always be compatible with the prudent approach. In other cases, some part of the financial return may be forgone in order to generate the social impact. These investments will also be compatible with the prudent approach providing administering authorities have good reason to think scheme members share the concern for social impact, and there is no risk of significant financial detriment to the fund.

Summary of requirements

In formulating and maintaining their policy on social, environmental and corporate governance factors, an administering authority:-

- **Must take proper advice**
- **Should explain the extent to which the views of their local pension board and other interested parties who they consider may have an interest will be taken into account when making an investment decision based on non-financial factors**
- **Must explain the extent to which non-financial factors will be taken into account in the selection, retention and realisation of investments**
- **Should not pursue policies that are contrary to UK foreign policy or UK defence policy**
- **Should explain their approach to social investments**

Regulation 7(2)(f) - The exercise of rights (including voting rights) attaching to investments

The long-term investment interests of administering authorities are enhanced by the highest standards of corporate governance and corporate responsibility amongst the companies in which they invest. Poor governance can negatively impact shareholder value.

Stewardship aims to promote the long term success of companies in such a way that the ultimate providers of capital also prosper. Stewardship activities include monitoring and engaging with companies on matters such as strategy, performance, risk, capital structure and corporate governance, including culture and remuneration. Engagement by administering authorities is purposeful and can identify problems through continuing dialogue with companies on these matters as well as on issues that are the immediate subject of votes at general meetings.

Engagement enables administering authorities as long term shareholders to exert a positive influence on companies to promote strong governance, manage risk, increase accountability and drive improvements in the management of environmental, social and corporate governance issues.

Administering authorities are encouraged to consider the best way to engage with companies to promote their long-term success, either directly, in partnership with other investors or through their investment managers, and explain their policy on stewardship with reference to the Stewardship Code. Administering authorities should become Signatories to the Code and state how they implement the seven principles and guidance of the Code, which apply on a “comply or explain” basis.

Concern has been expressed in the past about the scope of Regulation 12(2)(g) of the 2009 Regulations which, in effect, allowed each administering authority to decide whether or not to adopt a policy on the exercise of the rights attaching to investments, including voting rights. To increase awareness and promote engagement, Regulation 7(2)(f) now requires every administering authority to formulate a policy that reflects their stewardship responsibilities.

Summary of requirements

In formulating their policy on the exercise of rights, administering authorities:-

- **Must give reasons in their Investment Strategy Statement for not adopting a policy of exercising rights, including voting rights, attaching to investments**
- **Should, where appropriate, explain their policy on stewardship with reference to the Stewardship Code**
- **Should strongly encourage their fund managers, if any, to vote their company shares in line with their policy under Regulation 7(2)(f)**
- **May wish to appoint an independent proxy voting agent to exercise their proxy voting and monitor the voting activity of the managers, if any, and for reports on voting activity to be submitted annually to the administering authority**
- **Should publish a report of voting activity as part of their pension fund annual report under Regulation 57 of the 2013 Regulations**

Appendix 3

REPORT PREPARED FOR

North Yorkshire Pension Fund

Meeting of the Pension Fund Committee on 23rd February 2017

Governance Compliance Update

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[Report date: 9th February 2017]

Introduction

I last reported on the governance arrangements for the North Yorkshire Pension Fund to the Committee on 9th July 2015. While I would usually report annually on these matters, the Committee's business has, as with many LGPS funds, been heavily focused on preparing for and responding to the Government's proposals on pooling investment operations. In the circumstances, the need for a formal governance update was less pressing and I have been monitoring the Committee business during the period.

Since my last report and in addition to the focus on pooling, there have been significant developments in regard to governance concerning the issue of revised investment regulations, new DCLG and CIPFA Guidance, and the bedding in of the new local pension board. I refer to these issues in more detail below.

Notwithstanding the upheaval in operational and transitional arrangements faced, the Committee continues to maintain a high standard of governance in the administration of its responsibilities, and to make changes and improvements both to strengthen governance and to adopt industry-wide developments.

Executive overview

- ✓ I have reviewed the business and minutes of Committee meetings since July 2015 and I am satisfied that governance standards are being maintained and improved.

- ✓ There have been significant regulatory changes affecting the governance arrangements which are in the process of implementation.

- ✓ The Pension Board is operating effectively in line with its responsibilities.

- ✓ The new pooling arrangements represent challenges in establishing a workable governance structure for the future, integrating the Committee's existing responsibilities, with those in relation to the Border to Coast Pensions Partnership, and those relating to the Pension Board.

Recommendations

[1] That strategy and policy documents and governance arrangements are kept under review as the new pooling arrangements are finalised and the process of implementation moves forward.

[2] That the Pension Board works with the Committee and officers to both check and ensure compliance with new regulations and guidance issued over the past six months.

Independent governance oversight

The role of governance oversight has changed with the introduction of the Pension Board. While the responsibilities of the Committee in maintaining good governance have not diminished, pension board members now have a responsibility for ensuring compliance with regulations and guidance. In some respects this can lead to duplication of effort and it is important to differentiate the role of the latter in assisting the Scheme Manager to ensure compliance, notwithstanding the statutory responsibilities placed on individual Board members.

At the same time, many of the requirements that I have reported on over the past eight years have become embedded in the Committee's operations, including those most recent ones relating to the annual report. That is not to suggest any complacency but that the focus of governance oversight is changing and can be developed to be as effective and efficient as possible.

For my own part and recognising this change of emphasis, I have adapted my independent review work to cover the Committee and the Pension Board, as well as maintaining a general role of oversight and responsiveness. My role may need to adapt further as new governance frameworks and guidance emerge.

Core business activity

A review of the Committee's core business activity at meetings since July 2015 confirms that governance standards continue to be maintained and improved where necessary, although much of the Committee's and officers' time has been directed to developing pooling arrangements.

As I have indicated above, it has been necessary for the Committee to devote a significant amount of time to the issue of pooling which was introduced by the Government on a tight timetable. Nevertheless, in my view this has not impacted on the Committee's continuing high standards of governance in transacting business.

Annual Report and Accounts

The Committee agreed the report for 2015-16 at its meeting on 15th September, in a form that had been adapted to reflect the CIPFA guidance and is compliant. I would note that there is increasing pressure generally for the pension fund accounts to be produced earlier, i.e. by the end of September in line with the Council's main accounts.

The Committee is in line with this requirement but any move to bring the deadline forward would place added strain on the accounts closing process for the pension fund. This trend may be exacerbated by increasing demands for data from the Scheme Advisory Board, particularly in relation to investment costs under the new pooling arrangements.

Governance Compliance Statement

The Committee agreed a revised statement in September 2016 which is fully compliant with the guidance. This guidance issued by the DCLG in 2008 is now somewhat outdated although still relevant. As indicated in the Committee's revised Statement, further review will be required when the new pooling arrangements are in place.

North Yorkshire Pension Board

The Board has been both active and productive in the past year. I attended the Board meeting on 14th January 2016 and provided training on the governance framework. A work plan has been established and the Board's business at meetings has covered a broad range of issues consistent with its responsibilities.

I note that the chairman of the Board attends meetings of the Committee to report on the Board's activities and reports back to each Board meeting. The Board is seeking assurances where appropriate, e.g. external and internal audit reports, and has been kept informed of the pooling arrangements as these have developed. A review of employer and administering authority discretions has been undertaken, and the risk register has been reviewed. Training arrangements are reviewed regularly.

In my view the Board has a comprehensive work plan and is operating effectively. However, local pension boards have been given a wide ranging remit and extensive responsibilities within a relatively new governance structure, which is itself developing with the new pooling arrangements. The Board will need to remain vigilant in ensuring all its responsibilities are being addressed.

It is also important to be aware of external perceptions, particularly the Scheme Advisory Board. Their website provides scheme information on local pension boards in relation to compliance with the Public Service Pensions Act 2013 and this has been reviewed. The North Yorkshire Pension Board is shown to be compliant. I note that the section of the North Yorkshire website relating to the Board is comprehensive, providing basic information and details of the Board's activity at each meeting. This is more comprehensive than other funds I have seen and is to be commended.

Implementation of new pooling arrangements

I have monitored developments in the Committee's involvement and participation in the Border to Coast Pensions Partnership as have members of the Pension Board. The next stage is crucial in requiring the formal approval of Council to the proposed arrangements prior to 31st March. That process is current and it is not appropriate for me to comment on the arrangements at this time.

It is during this period that the issue of governance, among the many other areas to be addressed, will need to be developed. New governance arrangements will need to ensure that both the Committee and the Board can meet their responsibilities in relation to compliance with statutory requirements and guidance.

I note that the Committee has considered the Pool Governance Structure and received legal advice on the arrangements required. It will be necessary during the coming year for the Committee and the Board to review these new governance arrangements and any changes required to current policy and strategy statements.

CIPFA issued guidance on the governance principles for the oversight of LGPS asset pools last autumn. The guidance, which is advisory and not mandatory, sets out the key governance issues that the 89 LGPS funds in England and Wales must consider as the pooling proposals are developed ahead of planned implementation in April 2018.

The governance guidance document has been prepared by the CIPFA Pensions Panel with Aon Hewitt and is intended to highlight areas that individual funds should consider, including conflicts of interest and risk management, information and reporting requirements, and the responsibilities of chief finance officers.

Local Pension Board briefing

I have reviewed the notes from an asset pooling briefing with local pension board representatives held by the Scheme Advisory Board, LGA, HM Treasury and DCLG (these four represent 'the Panel') on 10th August 2016. Although this was some time ago and the Committee may have been advised on some of these issues, I thought it might be helpful to refer below to some relevant points in relation to governance.

Representation - Significant concerns were raised about the lack of representation on the governance structures designed to oversee the pools. The note states that *"without such representation, local boards, and member representatives in particular, would not be able to play an effective role in helping to ensure that investment and responsible investment strategies were being implemented by the pools"*.

In response, the Panel stated that there would be no mandatory membership of oversight structures and that it would be for each pool to develop the proposals they considered appropriate.

Transparency of costs - Mandatory disclosure of investment costs was requested but the Panel stated there was no authority to do so. Since then, the SAB has launched a transparency code to require disclosure of investment fees on a voluntary basis and a standard template is provided. Funds would be expected to encourage their asset managers to sign up to the Code.

Ownership and voting - A concern was raised regarding the impact of the common ownership of assets on responsible investment strategies. Clearly these are issues to be resolved in the new governance arrangements.

Impact on benefits - It is important to note the response to concerns raised about the potential impact on member benefits of any underperformance by pools, in particular through cost management arrangements:

"The Panel was unequivocal in reminding the meeting that benefits in the LGPS were statutory and were not subject to the level of, or variation in, investment returns. Both the SAB and HM Treasury cost management processes specifically excluded investment returns from the factors to be taking (sic) into account when assessing the future cost of the scheme. The risk of underperformance in investment returns was reflected solely in the deficit and met through increased employer contribution rates. It was, however, accepted that significant and continued growth in deficits could raise questions on the sustainability of the current benefit structure."

While none of this is new, it is helpful to have these views spelt out. Clearly local pension board members have an interest but this needs to be viewed in the context of their statutory duties. The position of the Committee is unchanged.

Revised investment regulations

The Committee considered the revised investment regulations and associated DCLG mandatory guidance at its meeting on 24th November. I understand that a new Investment Strategy Statement is to be considered by the Committee at this meeting.

While I expect the new ISS to be compliant with the regulations and guidance, the latter is particularly detailed and I will need to review compliance at a future date. The Pension Board will also need to familiarise themselves with the regulations and guidance to check compliance.

The new ISS must be approved and published by 1st April 2017. As previously, the strategy has to be reviewed at least every three years and the new pooling arrangements may require revision at an earlier date.

Funding Strategy Statement

The Committee has been reviewing the Funding Strategy Statement as part of the valuation process and a revised Statement is due to be considered at this meeting. In preparing the Statement, the Committee must have regard to CIPFA Guidance (Regulation 58). CIPFA issued revised guidance in September 2016.

As with the ISS, I expect the new FSS to be compliant with the regulations and the updated guidance and I will need to review compliance at a future date. The Pension Board will also need to familiarise themselves with the regulations and guidance to check compliance.

Other issues

Section 13 valuations - The Government Actuary's Department, appointed by DCLG as 'responsible authority', have completed a 'dry run' section 13 analysis based on the 2013 local valuations. This analysis assesses whether the four main aims - compliance, consistency, solvency and long term cost effectiveness - have been achieved.

This is in advance of a review of the 2016 valuation results under the Public Service Pensions Act 2013 - a copy of Section 13 is provided in ANNEX A for ease of reference. It is for each fund to discuss the implications with the fund actuary but there will be governance issues arising which affect the Committee and the Board.

Peter Scales
Independent Professional Observer

Public Service Pensions Act 2013 (extract)

13 Employer contributions in funded schemes

(1) This section applies in relation to a scheme under section 1 which is a defined benefits scheme with a pension fund.

(2) Scheme regulations must provide for the rate of employer contributions to be set at an appropriate level to ensure—

(a) the solvency of the pension fund, and

(b) the long-term cost-efficiency of the scheme, so far as relating to the pension fund.

(3) For that purpose, scheme regulations must require actuarial valuations of the pension fund.

(4) Where an actuarial valuation under subsection (3) has taken place, a person appointed by the **responsible authority** is to report on whether the following aims are achieved—

(a) the valuation is in accordance with the scheme regulations;

(b) the valuation has been carried out in a way which is not inconsistent with other valuations under subsection (3);

(c) the rate of employer contributions is set as specified in subsection (2).

(5) A report under subsection (4) must be published; and a copy must be sent to the scheme manager and (if different) the responsible authority.

(6) If a report under subsection (4) states that, in the view of the person making the report, any of the aims in that subsection has not been achieved—

(a) the report may recommend remedial steps;

(b) the scheme manager must—

(i) take such remedial steps as the scheme manager considers appropriate, and

(ii) publish details of those steps and the reasons for taking them;

(c) the responsible authority may—

(i) require the scheme manager to report on progress in taking remedial steps;

(ii) direct the scheme manager to take such remedial steps as the responsible authority considers appropriate.

(7) The person appointed under subsection (4) must, in the view of the responsible authority, be appropriately qualified.