Nottinghamshire County Council

Report to Pensions Sub-Committee

5 February 2015

Agenda Item:

REPORT OF SERVICE DIRECTOR – FINANCE & PROCUREMENT

LAPFF CONFERENCE 2014

Purpose of the Report

1. To report on the Local Authority Pension Fund Forum (LAPFF) Conference 2014 held in Bournemouth.

Information and Advice

2. The LAPFF Conference 2014 was held on 3rd to 5th December 2014 at the Highcliff Marriott Hotel in Bournemouth. In accordance with prior approval and as part of the Fund's commitment to ensuring those charged with decision-making and financial management have effective knowledge and skills, the conference was attended by Councillor John Wilkinson and Neil Robinson (Group Manager – Financial Management). The theme of the conference was Productive Investment: Public Funds and Public Purpose.

3. **Councillor Kieran Quinn, Chair of LAPFF; Sir Merrick Cockell, Deputy Chairman of the LPFA**
   The conference began with a welcome from Councillor Kieran Quinn who reinforced the reason for LAPFF's existence: to promote the long-term investment interests of UK local authority pension funds and, in particular, to maximise their influence as investors to promote corporate social responsibility and high standards of corporate governance amongst the companies in which they invest. He outlined the main themes of the conference: urban renewal, investment and working together.

   Sir Merrick expounded the view that funds should invest for the long term in infra-structure but that, individually, funds are not large enough. What is needed is collective investment, with larger pooled funds. Pooled assets would give an opportunity for constructive investment which would generate greater long term financial returns but also have the potential for delivering long term social benefits.

4. **LAPFF Engagement**
   This session began with Councillor Kieran Quinn outlining the main topics in which the LAPFF Executive and PIRC, its engagement partner, have been engaged. Each executive has their own particular expertise on which they can draw from their day job and which they can use to provide challenge to companies. The main topics included executive pay, employment practices, dividends, phone hacking, accounting policies and climate risk.

   Councillor Quinn cited two specific examples in which he has been involved:

- Trinity Mirror, where senior executives buried their heads in the sand with regard to a phone hacking problem in their organisation; they are now facing legal challenges;

- Remuneration practices at the banks where they got the equation wrong vis a vis shareholder and executive financial rewards; Barclays in 2009 and the fixing of the LIBOR.

Councillor Richard Greening, LAPFF Executive & Chair of LB Islington PF outlined his involvement in two further topics:

- National Express, where the unions have raised concerns over issues of health and safety on the "yellow school buses" in the U.S. With the company refusing to engage with the issues, LAPFF is gathering evidence and pressing the board to set up an independent review;

- Discussions with the Chairs of the boards of Shell and BP over remuneration, safety, carbon disclosure, shale gas and the oil price. The Chairs have shown their appreciation of LAPFF's support in building relations and keeping issues alive.

Cllr Cameron Rose, Vice Chair of LAPFF, Lothian Pension Fund summed up the session by reflecting on LAPFF's constructive but challenging approach.

5. **How Better Business Practice Can Drive Both Market & Social Returns**
In the next session Cherie Blair, CBE, QC, Chair Omnia Strategy LLP started by reflecting on the changes that have taken place since she started her career in the 1970s; human rights were talked about more in the abstract in those days with a focus more on tyrants. Now we are in a world where corporate social responsibility and good corporate governance are high on the agenda. LAPFF encourages the view that human rights are important and there is also a public demand for it. Consumers' behaviour through their purchasing practices are encouraged to buy from ethical companies and they are showing their willingness to do so.

For Ms Blair the message is clear; companies are well advised to look beyond the bottom line to see what will bring long-term returns. It is important to keep investors and staff (with an eye on productivity) happy. There is a need for robust corporate governance and LAPFF can offer a unique and fresh perspective for management because of who the organisation represents, i.e. customers and shareholders.

Given the leverage that they have because they hold the key to capital, Ms Blair cited several instances where pressure from investors has made a difference; from the Norwegian State Pension Fund that has strict investment criteria which makes it stronger, to the Japanese fund which is currently strengthening its investment criteria and which form part of the current Japanese Prime Minister's economic reforms.

6. **What Kind Of Infrastructure Investment Do We Need?**
Mike Weston, CEO of Pensions Infrastructure Platform LTD summed up the answer to this question at the start of his presentation as "The kind that helps us pay pensions!" He then went on to consider the answer in more detail from the different perspectives of the country, local authorities and UK pension schemes.

The Chief Secretary to the Treasury launched 'Investing in UK Infrastructure' at the Commonwealth Games Business Summit in July 2014. It sets out the reasons why the UK is a great place to invest, highlighting the country's strong regulatory regime, streamlined planning system and support for finance. The guide also provides a clear market overview of the sectors where investment opportunities exist and details specific projects which are seeking third party investment. In addition, Infrastructure UK has been established as a dedicated unit within HM Treasury with responsibility for coordinating and simplifying the planning and prioritisation of investment in UK infrastructure, together with achieving greater value for money on infrastructure projects and transitions.

NAPF has called for an 'Infrastructure Minister to provide cross departmental coordination, to deal with tax and regulatory issues and to also provide the right kind of investment opportunities.

From a local authority perspective the main issues relate to:

- social versus fiduciary pressures
- local versus national projects
- separate versus pooled approaches (regional or national groupings)

Infrastructure investment by UK pension schemes is low by international comparison, despite the national need. The reasons for this relate to various factors such as scale prohibiting direct investment, poorly structured third party funds and high fees. There is also what Mr Weston calls the "persistent illiquidity fallacy": the argument that investment in infrastructure is illiquid. He argues that, on the contrary, operating infrastructure assets are easy to value, limited partnership shares can be bought and sold and, anyway, just how much liquidity does a pension scheme actually need (to ensure pensions can be paid and to avoid being a forced seller of assets)?

Mr Weston concluded that we get the right kind of investment by having the right investment vehicles, investor pooling and less focus on liquidity. There is an accepted need for infrastructure investments in the UK and pension funds are ready to fund it (having the right characteristics and fund structures). Structural issues, however, make it difficult to access and advisors/consultants need to translate client enthusiasm into action, to move away from the "illiquidity fallacy".

7. **No Stone Unturned, Urban Regeneration**

The Rt Hon The Lord Heseltine, Former Deputy Prime Minister started his presentation with the observation that the world is awash with money and that local government pension schemes represent mountains of cash. There are, though, serious obstacles to getting this "wall" of money into regeneration. Firstly, there is no intellectual blockage because there is a consensus that the money is needed. There is, however, no agreement between the institutions / Treasury about what the "deals" should look like.

Lord Heseltine cited two main reasons for this:

- Individual pension schemes are too small – they need to join together in some way;
- The construction risks are formidable, with 60% of Government-let construction either running over budget, time or both.

Lord Heseltine observed that, on big projects like HS2, there is little press coverage on the possibility of reducing public sector costs by making deals with institutions. Also, with regard to social housing, this costs taxpayers huge amounts but there is nobody in charge. He gave an example of a council estate with high levels of unemployment and with a job centre that is 2 miles away – a £2 bus journey there and £2 back. But there is a local authority office on the estate, so why not move the job centre to the local authority office?

Lord Heseltine argued that there is a window of opportunity opening with the recent "Scottish Deal" making devolution unstoppable in England. The Local Enterprise Zones, comprising LA leaders, vice chancellors and representatives from big/small companies are bidding for larger pots of money and they will have to have strategies for growth with specific projects to build local economies. Pension funds belong to the public and local people and these funds should be brought to the table in order to meet the needs of building the local economy.

8. **Shredded Inside RBS**

In a punchy presentation Ian Fraser, Journalist & Author described the banking crisis and, in particular, the story of the Royal Bank of Scotland (RBS). He started by highlighting the fundamental reasons for the crisis.

Institutional investors had a role in the build up to the global crisis through the 1990s up to 2008 by driving banks to "cheat". For example Lloyds engaged in the industrial scale mis-selling of PPI packages, with others following suit in conning clients in a very profitable business. Mr Fraser contended that having the finance/banking sector as a National champion is dangerous – banks write their own rules and will write them in their own favour. Governments were persuaded that regulation would be disastrous and they were basically in the bankers' pockets. Auditors were paid by the banks but had vested interests and credit rating agencies were bribed to give fraudulent ratings for worthless bundles of debt.

Internally, banking staff were dealt with on a "rank and yank" basis: sell, sell, sell, with the bottom 10% performers sacked and the top 10% given bonuses. RBS had inept boards with a lack of diversity and lots of back slapping. The CEO was vilified by the Government in 2009 and can be seen as a convenient scapegoat but under his leadership the bank became too big, with a monumental failure to invest in ICT – RBS reportedly had 38 recording systems that were not integrated properly which made an assessment of the total exposure to risk impossible.

In Mr Fraser's view, the bail out (under Gordon Brown) was flawed. The investment of £500 million had no enforceable strings and the Government was itself being advised by bankers who hoped for a return to the status quo. RBS should have been nationalised, culled and reorganised. (President Obama also failed to force reform home in the USA.)

Now RBS has an unreformed culture and recently has been fined £400 million for rigging financial equity markets and £56 million (in 2012) for letting an ICT meltdown occur that left thousands of customers unable to access their money.

9. **International Activism**

The next presentation began with a video recording of James Hoffa, General President, International Brotherhood of Teamsters, in which he thanked the LGPS and LAPFF for trying to shake up National Express over the issue of school buses in the USA.

The presentation was continued in the auditorium by Louis Malizia, Asst Director, Capital Strategies Dept, International Brotherhood of Teamsters who outlined the issues faced by the Union in trying drive up standards for workers employed by First Group and National Express. Both companies are involved in the profitable market of providing the school (yellow) bus service across America.

Following privatisation the employees were low wage, part-time and with no retirement planning and a ban on collective bargaining. The Union met with employees of First Group, wrote to the Board and filed resolutions at the company's AGM. This resulted in a big win, with new contracts being issued to employees in 2010. Unlike First Group, National Express has so far, however, according to Mr Malizia, engaged in intimidation and illegal firing in not isolated incidents involving rogue managers, with the company taking an unsustainable path.

The Teamsters have, therefore, reached out to UK investors. LAPFF introduced a resolution in 2014 encouraging the National Express Board to do something positive. This prompted the Board to engage in delaying tactics but eventually the resolution appeared on the AGM's agenda (as the last item) and received a 13% vote in favour – a solid base with which to engage the company. A further resolution asking for an independent review to be commissioned is to be introduced to a future Board meeting.

Yasuaki Kinoshita, Chief Portfolio Manager, Nissay Asset Management ended this session by giving delegates an update on corporate governance reform and shareholder engagement in Japan.

Japan has probably passed the worst (in particular, two decades of deflation). Deflationary pressure has eased significantly since the central bank took new steps to ease the money supply in 2013 with an inflationary target of 2% and the Japanese equity market finally bottomed out after a depressingly long period of time. Many more Japanese corporations have achieved record sales and profit numbers in recent years. In December 2012 Japan's Prime Minister Shinzo Abe initiated an economic policy (now called Abenomics) based on the "three arrows" of:

- Monetary easing (reflation)
- Fiscal stimulus (government spending)
- Structural reform (growth strategy)

These are starting to show some encouraging results.

Typical Japanese corporate managers in previous decades did not speak with foreign investors in English, did not care about return on equity and were not interested in future growth. This was because Japanese corporate managers did not have to care about shareholders; Japan's corporate governance system did not require it. Now, the shareholder structure has dramatically changed and corporate managers are no longer able to continue the old way of business; nearly 60% of shares are now owned by institutional investors, foreign investors, etc. Prime Minister Abe believes that more active engagement between corporate managers and shareholders should improve corporate competitiveness in the global market and enhance shareholder's value through increasing growth opportunities, improving management efficiency and boosting returns to shareholders. In response corporate managers are increasing the number of independent directors, increasing dividends and share buybacks, setting ROE targets in medium term plans and they are becoming more receptive to shareholders. Mr Kinoshita firmly believes that “this time is different”!

10. **LGPS Issues**
The first day of the conference ended with a consideration of three of the main hot topics that are currently on the LGPS agenda.

- Governance
- Fiduciary Duty
- Value for Money

The four protagonists were Bob Holloway, DCLG, Cllr Kieran Quinn, Chair of LAPFF & GMPF, Cllr Denise Le Gal, Chair Surrey CC Pension Fund and Terry Crossley, Barnett Waddingham.

Bob Holloway described the current position on pension boards, the consultations in June and October and his expectation that regulations will be issued in (early) January 2015. Terry Crossley queried whether the establishment of a board would actually improve accountability; it was never asked for by Hutton. He did confirm, though, that it is possible to share a board as long as a joint committee exists.

With regard to fiduciary duty the role of councillors as trustees was discussed, particularly in relation to ESG issues and boundaries. The panel’s view was that investment in tobacco is still valuable, as is that in the defence industry. Trustees should delegate the investment decision to fund managers and trust them. Pension funds want the best returns within the law and returns are paramount.

As far as value for money is concerned, delegates were informed that the idea of mandatory merged funds is dead. Although collective investment vehicles are being encouraged these, again, would not be mandatory.

11. **Sorry, Wrong Number**
The second day of the conference began with Tim Bush, PIRC LTD describing some of the recent “headline grabbers” relating to problems with company accounts and the failings of auditors. He started with Parmalat. Having become the leading global company in the production of long-life milk using the ultra-high-temperature (UHT) process, the company collapsed in 2003 with a £13bn hole in its accounts in what remains Europe's biggest bankruptcy. The auditors were Deloittes, but it wasn’t until Marco Ricci, investment director of the €2.4 billion Hermes European Focus Fund, asked the right questions that fraud was identified. The best question was “Why was Parmalat debt showing on Bloomberg screens but was not in the Parmalat accounts?” Parmalat’s response was to send letters to 6 Hermes employees promising them a slow and painful death, whilst the management fled to Ecuador. Why hadn’t the auditors asked the question?

In the case of Tesco in 2014, the false accounting for commercial income in the UK retail business went back for at least 3 years. This came to light when a new CEO was appointed and a whistle-blower divulged the information – it is interesting that they did not feel able to go to the auditors, PWC. Mr Bush pointed out that it is a criminal offence in the UK for anyone to mislead an auditor; so are the auditors speaking to the right people?

The Bank of England review of the Co-op Bank in 2013 revealed several issues including overstated loans. Some time before, after the financial crisis, the Financial Reporting Council (the UK's independent regulator responsible for promoting high quality corporate governance and reporting) carried out a review of bank audits during which it had reviewed Co-op's 2011 accounts audit and passed it. The detail of the review, though, showed that KPMG had audited loans that Co-op had made provisions against but it had not audited their sufficiency or loans that had not been provided for. Loans were massively overvalued.

Mr Birch, after citing several more examples of dubious auditing and accounting practises, set out LAPFF's approach to encouraging "reliable accounts":

- Being attentive to specific problems with company accounts
- Focussing on the auditors and accounting standards
- Being active with the investor coalition
- Initiating engagements

12. **Executive Pay**

The second slot of the morning involved a discussion on "what now for executive pay?" involving Cllr Kieran Quinn, Chair of LAPFF & GMPF, Natasha Landell-Mills, Sarasin & Partners and James Upton, Senior Manager, Governance, BHP Billiton. The panel started by describing what is wrong with pay for senior executives:

- It is too high – Over the last 15 years the pay for the average CEO has increased from 16 times the average UK worker to 160 times. In recognition of this the political discourse has changed from Peter Mandelson MP in 1998 being "intensely relaxed about people getting filthy rich" to Christine Lagarde's, (Head of the IMF) quote in May 2014, "capitalism has been characterised by excess – in risk taking, leverage, opacity, complexity and compensation. It led to massive destruction of value. It has also been associated with high unemployment, rising social tensions and growing political disillusion".
- There is an inadequate link to performance – Even after reforms in the UK, headlines include "Barclays – profits down, bonuses up". There is beginning to be recognition that the rationale for executive pay: to attract, retain and motivate, is nonsense and that it is impossible to design a package that does that.
- Accountability lacks teeth – despite remuneration consultants being described in the press as "arms dealers in arms race" shareholders have almost never voted a remuneration report down.

In discussing what could be done, the panel considered reducing the number of key performance indicators on senior executives' scorecards and going back to basics: salary + a share based bonus. In addition, there needs to be recognition that money isn't everything. In driving the change the Government is already taking action given the corrosive impact of inequality and market failure: in April 2014 FTSE 100 remuneration committee chairs were informed that action would inevitably result if they were unable to curb pay increases. Government action is mostly about making the market work better by strengthening accountability to shareholders and pushing them to behave long-term.

13. **Board Diversity & Director Competencies**
Laura Carstensen, Non-Executive Director, Equality & Human Rights Commission and Fiona Reynolds, CEO, Principles for Responsible Investment (PRI) began their presentation by stating that board diversity (gender, race, age, etc.) is the hallmark for well-run companies.

Ms Reynolds stated that women globally represent 19% of board members, with representation ranging from 29% on pension boards, to 21% on asset management companies' boards and 10% on the boards of trade bodies. Quotas and targets, she said, do matter with Norway being the first to introduce one for gender balance. Other Scandinavian countries have followed and now France and Spain have introduced a target of 40% female board representation to be achieved by 2016. One of PRI's (of which she is CEO) aims is to foster good governance and its members are engaging with companies to improve effectiveness.

Ms Carstensen added that if non-executive directors are stripped out of the figures then the position is a lot worse. Companies need adequate diversity statements and companies need to be challenged to encourage them to tap in to what she sees as a pipeline of female talent. She finished the presentation by expressing her surprise that after many years she's still talking about it!

Statutory and Policy Implications

14. This report has been compiled after consideration of implications in respect of finance, the public sector equality duty, human resources, crime and disorder, human rights, the safeguarding of children, sustainability and the environment and those using the service and where such implications are material they are described below. Appropriate consultation has been undertaken and advice sought on these issues as required.

RECOMMENDATIONS

1. That it be noted that attendance at key conferences is part of the Fund's commitment to ensuring those charged with decision-making and financial management have effective knowledge and skills.

2. That the report be noted.

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Constitutional Comments

15. Because this report is for noting only, no Constitutional Comments are required.

Financial Comments (SRC 27/01/15)

16. There are no direct financial implications arising from this report.